



**CHASE**

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June 4, 1999

Mr. Timothy S. Lucas  
Director of Research and Technical Activities  
Financial Accounting Standards Board  
401 Merritt 7  
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**Letter of Comment No:** 95  
**File Reference:** 1082-194R  
**Date Received:** 6/8/99

Re: File Reference No. 194-B  
Exposure Draft on Consolidated Financial Statements: Purpose and Policy

Dear Mr. Lucas:

The Chase Manhattan Corporation (Chase) appreciates the opportunity to comment on the FASB's February 23, 1999 Exposure Draft of the Proposed Statement of Financial Accounting Standards, Consolidated Financial Statements: Purpose and Policy (the ED). We have also participated in several industry associations that have submitted comment letters on the ED. Our letter reiterates certain of the issues raised in those letters, in addition to providing several other additional concerns of ours for the Board to consider.

Although Chase commends the Board's further attempt to clarify the definition of "effective control" and to revise and expand on the related implementation guidance, we disagree with the conclusions contained in the ED and opposes its issuance as a final standard.

Chase continues to believe that the fundamentals of consolidation accounting should rest upon a sound conceptual foundation that yields consistent and reliable results and, at the same time, is both easy to understand and to apply. The existing "majority voting interest" criterion currently meets all of these criteria. Additionally, our view is collaborated by the fact that few users of financial statements have expressed significant concerns about existing practices in this area.

Before any new consolidation standard is adopted, it should improve comparability and consistency of the information provided, as discussed more fully in paragraphs 188 and 208. We do not believe the ED will result in such an improvement in comparability and consistency. The issuance of this standard will produce highly judgmental and subjective reporting results that will defeat these objectives of financial reporting. Entities assessing individual facts and circumstances surrounding a potential control

relationship will differ in their interpretations. This would lead to inconsistent application in practice. We based this upon a review of the eight examples posted to your web site. A group of our senior most staff independently analyzed the fact patterns, and consistently came to different answers as to whether the entities should be consolidated. If these simpler examples presented such difficulties, then we are concerned with real life situations like multi-seller asset-backed commercial paper vehicles.

If the Board proceeds with a consolidation standard, then significant changes should be made to the ED to fully address the following issues:

### **Scope Exemption and Transition**

The Board should align the timing requirement of the ED with its other related projects. The proposed amendment to SFAS 125 includes modifications to the definition and the consolidation requirement of qualifying SPEs. In this regard, Chase is extremely concerned with the timing difference between the comment period on the ED and the issuance of the exposure draft of the SFAS 125 Amendment. Without knowledge of the conditions under which an SPE would be qualifying under the Amendment and not require consolidation, we are unable to adequately assess the full impact of the ED on the consolidation of SPEs. Accordingly, we recommend the Board consider postponing the comment deadline for the ED beyond May 24, 1999 until after the release of the exposure draft of the SFAS 125 Amendment.

Separately, the ED would not apply to financial statements of certain reporting entities, including investment companies that apply the provisions of the AICPA Audit and Accounting Guide, Audits of Investment Companies, and report all changes in value in a statement of operations. As you are aware, a special task force of the Accounting Standards Executive Committee (AcSEC) has been established to develop a statement of position (SOP) to address the scope of the Guide. The project is to address whether more specific attributes of investment companies can be identified that could be used as criteria that must be met to apply the provisions of the Guide. Similar to our comment above regarding the SFAS 125 Amendment, we are unable to assess the impact of the ED on entities that might be affected by the SOP. Accordingly, the Board should either clarify the ED's scope exemption with respect to investment companies or postpone the ED's proposed effective date until the SOP is issued.

The proposed effective date of December 15, 1999 is also not realistic. The implementation of the ED as drafted will require the re-assessment of numerous potential control relationships. Since this will require significant resources and senior management involvement, it is not practicable for this to be completed during the fourth quarter of this year (assuming the ED is issued as a final standard by September 30, 1999). We, therefore, recommend that the Board postpone the effective date to reporting periods beginning after December 15, 2000.

### **Definition of Control**

Consolidation should be required when one entity has 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 that have the rights to elect or appoint a majority of the governing board. If an entity owns less than a majority of the voting rights of another entity, then the investor generally does not have the power to direct the policies and management of the ongoing activities of the investee. Situations in which an entity owns less than a majority of the voting rights, but, nevertheless, actually controls the other entity are rare.

Further, a consolidation policy based on the ownership of a majority of voting rights is more objective, is easier to apply, and consequently is conducive to consistent applications, which will generate comparable financial reporting results. When control is deemed to exist through effective control, it becomes much

more difficult to determine at what point the ability to influence the policy and management of 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. A consolidation standard based on the concept of effective control will produce highly judgmental and subjective reporting results, which severely weakens comparability. In paragraph 200, the Board acknowledged that the requirements of the ED are not expected to add significantly to the number of entities to be consolidated. Thus, it becomes questionable whether the issuance of the ED as a final standard that is not expected to improve financial reporting is cost justifiable.

### **Presumptions of Control**

Chase concurs with the views of the dissenting Board member that the presumption of control should be limited to circumstances described in paragraph 18(a), i.e., when an entity “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,” since this is the only set of facts and circumstances that provides compelling evidence pointing toward control. Existing consolidation accounting requires consolidation when there is a controlling financial interest, for which the usual condition is ownership of a majority voting interest. The existing “majority voting interest” criterion generally results in the consolidation of entities that are “controlled” by the parent.

Paragraph 18(b) of the ED states that it is appropriate to presume that an investor who acquires a large minority voting interest in an entity would have the ability to dominate the election of that entity’s governing body if no other party or organized group of parties has a significant voting interest. This implies that the large minority voting interest holder in this case has unilateral ability to control the entity. We disagree because the ability of the large minority voting interest holder to exert control in this case depends substantially on the action or inaction of the majority voting interest. The majority voting interest may at any time veto or negate the large minority voting interest’s attempt to exert control. As recognized by the Board in paragraph 31, whether an entity presently has the required decision-making ability does not depend on whether and how an entity with the required decision-making ability chooses to use that ability. This should apply equally to the majority voting interest holders who have the ability to veto a large minority voting interest but choose not to do so.

Further, Chase is troubled by any standard that requires consolidation or deconsolidation based on simple shifts in the voting patterns of the shareholders, where the level of actual control has not changed. For example, an investor holding 40 percent interest might consolidate if historically only 75 percent of the shareholders vote. Consolidation may not be appropriate if 85 percent vote in the following year. A decline of the voting level below 80 percent in the subsequent year could again point to consolidation. Such a policy will not generate relevant and comparable consolidated financial statements.

Chase believes that a meaningful consolidation policy should be based on current and actual control. The potential to obtain control in the future does not give an investor current control. Therefore, in that circumstance, the inclusion of the assets, liabilities, revenues and expenses, gains and losses, and cash inflows and outflows of an investor in the consolidated financial statements of an investor would diminish the representational faithfulness and usefulness of the information provided by those financial statements. The ability to control should be legally enforceable through current ownership of the majority of voting interest. It should not be based on an uncertain future event.

Paragraph 18(c) of the ED states that it is appropriate to presume control if an investor has the ability to obtain a majority voting interest in the election of a corporation’s governing body through the ownership of convertible securities or other rights currently exercisable and the expected benefit from converting those securities and exercising those rights exceeds its expected cost. We strongly disagree for the

reasons stated above. In this case, there is no compelling evidence or basis for presuming the presence of control, until the investor converts those securities or exercises those rights to obtain actual control through the majority voting interest.

The ED is also unclear as to how consolidation is effected in practice through the ownership of convertible securities. Should the holder of a majority voting interest be exempted from consolidating a subsidiary because the holder of a large minority voting interest is presumed to have converted its convertible debt? Should the holder of a majority voting interest who also holds convertible debt be required to assume conversion of such securities, thus changing its ownership percentage of the subsidiary? The Board should review the potential complications arising from the requirements of the ED and ensure that results are meaningful and the necessary implementation guidance is provided.

Furthermore, it is inconsistent to presume inaction by the holder of the majority voting interest to veto or negate the large minority voting interest's attempt to exert control in 18(b), but to presume future action by the holder of the convertible securities to convert the securities to obtain actual control through the majority voting interest in 18(c).

Chase is also concerned with paragraph 21, where a sole general partner in a limited partnership is presumed to have the ability to direct the policies and management of that partnership if no other partner or organized group of partners has the current ability to dissolve the limited partnership or otherwise remove the general partner. The limited partners may have had no need to test their ability to change or remove the powers delegated to the general partner, until the general partner directs the policies of the partnership in ways unacceptable to the limited partners. It is unlikely the sole general partner can direct the policies and management of the partnership in such ways that would result in increasing the benefits and limiting the losses of the general partner without the ongoing cooperation or acquiescence of the limited partners. In many cases, a sole general partner who has managerial expertise may be, in substance, no more than a manager for the limited partnership, or may be so nominated purely for tax reasons. In the case where a sole general partner holding a one percent economic interest is presumed to control and consequently is required to consolidate a partnership, the general partner's financial statements, which would reflect a 99 percent minority interest, would hardly be relevant or useful information for users. Therefore, we do not believe there is a strong basis for presuming the presence of control by the sole general partner as contemplated in the ED.

### **Other Issues**

If the Board decides to retain the presumption of control by a sole general partner of a limited partnership as currently described in paragraph 21, then it should clarify the "removal of general partner" requirement in this paragraph. In this connection, it should be sufficient to overcome a presumption of control if the limited partners have the power to "remove the general partner's ability to function as a general partner," instead of the power to force the general partner to divest from the partnership. The focus should be on the removal of the general partner's power, instead of the removal of the general partner itself.

The ED should similarly clarify the application of the concept described in paragraph 21 to situations where a manager may be viewed as having "control by contract" over an SPE, such as an administrative agent for asset-backed commercial paper conduits. In this case, an administrative agent provides various services to the conduit based on an arm's length agreement and does not have nonshared decision-making ability to direct the policies and management of the conduit's ongoing activities. Therefore, for purposes of applying the provisions of paragraph 9 of this ED, the existence of control by the administrative agent of the conduit should not be presumed if by contract, the administrative agent can be removed of its function without cause. To require consolidation of a conduit by an administrative agent would result in reflecting the assets and liabilities of an entity that the administrative agent does not control in its

consolidated financial statement, which is another example of reporting information of doubtful relevance and usefulness.

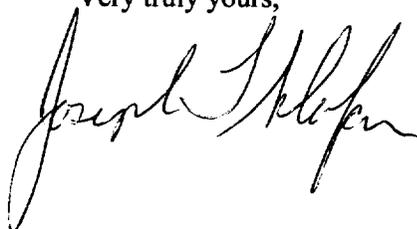
The ED should further clarify the requirements with regard to mutual funds and other similar investment arrangement. Chase agrees with the Board's position that a fund manager or investment advisor should not be required to consolidate the fund, since the manager or the advisor is hired and delegated the responsibility for deciding how to invest the fund's assets but generally cannot obtain and control the future economic benefits of those investments. Since an investment in a mutual fund is accounted for as equity securities under SFAS 115, instead of an equity method investment, the ED should clarify that when a manager also owns shares of the fund, the manager, who in this case is no different than any investor of the fund, should follow SFAS 115 to report the investment in the fund at its fair value. To be free from doubt, the ED should further clarify that a manager/investor who owns a majority of the shares of a mutual fund should follow SFAS 115 to report the investment at its fair value and is not required to consolidate the mutual fund. Consolidation would be inappropriate in either of these two situations because the holder of shares in a fund is entitled only to the proportional return on those shares actually owned.

In addition, as indicated in the examples in Questions 60, 61 and 62 contained in the FASB Special Report, A Guide to Implementation of Statement 125, Second Edition, a qualifying SPE is permitted to hold equity securities. Therefore, the Board should also clarify that a SPE that holds an interest in a mutual fund can be qualifying provided the provisions of paragraph 26 of SFAS 125 as interpreted by Topic D-66 are not violated. This clarification could be made either in the ED or in the proposed Third Edition of the Guide to Implementation of Statement 125. This is yet another illustration as to why it is critical for the Board to align the timing requirement of the ED with the SFAS 125 Amendment and the related Implementation Guide.

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Chase appreciates the opportunity to submit its views on the ED and is available to participate in any discussions regarding the impact of proposed changes in consolidation guidance. If you have any questions or would like to discuss this letter, please do not hesitate to contact me or David M. Morris at (212) 701-7007.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Joseph Sklofen".