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Mr. Timothy S. Lucas  
Director of Research and Technical Activities  
Financial Accounting Standards Board  
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**Letter of Comment No:** 31

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Re: File Reference No. 194-B

Dear Mr. Lucas,

Thank you for the opportunity to comment on the exposure draft of the Board's proposed statement, *Consolidated Financial Statements: Purpose and Policy* (the "ED").

Although we take no issue with the theory of control underlying the ED, we believe that control should be accompanied by meaningful economic interest before consolidation is appropriate. As such, we believe that the ED will yield less meaningful financial information than current standards provide for the following reasons:

- The ED would require consolidation of certain entities in which the financial statement preparer has little or no economic interest in the "controlled" entity. We fail to see how this accounting would provide useful information to the users of those financial statements. On the balance sheet, all or virtually all of the entity's assets would be funded by minority interests. Likewise, on the income statement, all or virtually all of the entity's earnings would be attributed to the minority interests. For many preparers, consolidation of these entities would be highly distortive to their financial results or position.
- The ED's premise of control will likely result in investment managers consolidating investment vehicles when (i) their compensation has been aligned with investors' interests and (ii) there is any limitation whatsoever on investors' right to remove them as manager.
- The ED's guidance is very subjective in that it requires (i) assessments of the probability that "control" rights will be exercised and (ii) prioritization of various "control" factors, which would inevitably result in inconsistent application among practitioners.

We therefore question the need for a new standard on consolidation since the current standard yields consistently prepared and reasonably useful financial information. Should the FASB continue with the project, however, the following comments highlight issues that should be considered by the Board.

### **Management Relationships**

The premise of control set forth in the ED would result in certain entities that act in an investment management capacity to consolidate the entity for which they manage investments. Although the ED provides an exemption for investment managers of funds registered under the Investment Company Act of 1940 ("1940 Act"), other investment managers may be required to consolidate the entities they manage. For instance, a non-1940 Act fund may not have the same annual approval of the investment manager as 1940 Act funds have, but investors typically have the ability to remove the manager for cause. The ED makes a distinction between an unfettered right and a conditional right to remove the investment manager. From a practical standpoint, investors in both 1940 Act and non-1940 Act funds will likely remove a manager under the same circumstances (e.g., poor performance as manager). We don't understand why a distinction should be made if the ED requires evaluating the underlying substance of rights and responsibilities.

The ED also states that fund managers who receive bonuses for performance would not be required to consolidate the fund provided that there is an equivalent potential penalty for underperformance. Thus a fund manager that can receive a bonus for performance, but is not penalized for underperformance, would be required to consolidate that fund. Fund managers typically receive compensation for fund management that varies from fund to fund. Accordingly, a fund manager would be required to consolidate some funds that it manages but not others, even though they perform identical functions for all.

Funds may take the form of trusts, partnerships, or corporations. In the case of limited partnerships, the investment manager is likely to be a 1% sole general partner whose duties may also include fund administration. The ED, however, presumes that a sole general partner has "control" of a limited partnership. The general partner, like a non-partnership fund manager, may "control" the assets of the limited partnership, but can not use the assets to achieve economic benefits beyond what is contractually determined at the origination of the transaction (i.e., a management fee). By virtue of its nominal ownership, the general partner's economic interests are automatically aligned with limited partners' interests.

Consolidation of funds by a fund manager would yield nonsensical financial statement results. The balance sheet would be grossed up with assets that bear no resemblance to those of the fund manager, with a minority interest equal to all or virtually all of the net assets consolidated. Key ratios, such as return on assets, return on equity, leverage, regulatory capital adequacy, and profit margins, would be distorted. The income statement would contain all the revenues generated by the fund or partnership, which would be fully or substantially negated by the minority interest attribution.

### **Determination of Control**

The ED's definition of control, together with the accompanying discussions, defines control so broadly that it creates a higher hurdle for non-consolidation than for consolidation. We are concerned that, when control and risks and rewards are shared in a manner other than a clear 50/50 split, each of the controlling parties may conclude that it controls the controlled entity, due to the subjective nature of the control definition (Issue 1).

In the determination of control, the ED would require consideration of control rights, the probability of exercise of those rights, and risks and rewards of assets in the entity. Control rights can take on different forms (voting rights, ability to obtain voting rights, management responsibilities, operating duties), while risks and rewards can also take alternative forms (direct ownership, management fees, residual interests, guarantees). We are concerned that, due to the subjective nature of these items and the need to prioritize these often-conflicting items to conclude on control, there will be diverse interpretations in practice leading to a lack of comparability of financial information. The case studies published by the FASB Staff illustrate multiple examples of “close calls” that, in our opinion, would result in inconsistent conclusions formed by practitioners.

Assessing the probability of exercise of control rights is very judgmental:

- In cases where one shareholder has a large minority stake, the ED requires prediction of the percentage of votes to be cast in a corporate election in order to determine whether that minority shareholder has an expected majority of votes to be cast. This assessment is difficult to make since past voting patterns are not necessarily indicative of future results.
- The ED would require the evaluation of whether an entity has the ability, through options or convertible debt, to gain control of another entity and whether the benefits of conversion outweigh the costs. The difficulty in this analysis is determining the value of the benefits an entity would derive from its conversion.
- The ED would not require a general partner to consolidate a partnership if the limited partners have the ability to remove the general partner. The exposure draft requires an analysis as to whether the limited partners have both the right *and* ability to organize and remove the general partner. Predicting whether the limited partners will organize is dependent upon whether there will be reason to organize (e.g., dissatisfaction with the general partner’s performance).

For these reasons, we believe that having rebuttable presumptions of control contributes to a bias toward consolidation (Issue 2).

### **Special Purpose Entities**

The ED sets criteria for the consolidation of special purpose entities, such as trusts and other limited purpose entities. The consolidation of these entities is currently addressed in SFAS No. 125 and several EITF Issues. We are confused about the status of existing guidance as it pertains to qualifying special purpose entities (“QSPEs”), such as Issue 96-20. We surmise that, based on preliminary draft provisions in the amendment of SFAS No. 125, a transferor, servicer, or sponsor would not consolidate the QSPE and would only recognize QSPE assets to the extent of beneficial ownership of the QSPE.

For non-QSPEs (i.e., those entities not meeting the criteria of Issue D-66), it is unclear whether Issues D-14 and 90-15 would still apply and, if so, how would they interrelate with a final consolidation standard.

### **Scope**

Under the ED, entities that carry substantially all of their assets at fair value are not required to consolidate entities in which they maintain controlling investments. This exemption primarily applies to investment companies, including mutual funds and venture capital and merchant banking funds. In certain instances, the ED would require these investment companies to be consolidated by another reporting entity (see Management Relationships section). It is unclear as to whether the exemption would carry over to the reporting entity that consolidates the investment company. We believe that the reporting entity would report the assets and liabilities of the investment company and not the assets and liabilities of any investee of the investment company. We suggest that this point be clarified in the final standard.

### **Transition**

The final standard would be effective for fiscal years beginning after December 15, 1999, including interim periods in that year. If issued, we urge the Board to consider an effective date of fiscal years beginning after December 15, 2000 for the following reasons:

- The Board also plans to issue an amendment to SFAS No. 125, which will also contain guidance as to the consolidation of SPEs. We understand that this amendment will be effective beginning January 2001. Due to the interaction between the amendment and the ED, we believe the effective dates for both standards should be identical.
- Issue 3 of the ED asked if the statement should be applied to interim periods in the year of adoption. It would be difficult to implement a new consolidation standard beginning with the first quarter of 2000 if a final standard is not expected before the fourth quarter of 1999. Because Merrill Lynch has relationships with more than 1,000 limited purpose entities, implementation as of first quarter 2000 would be impracticable.

In addition, the standard should not require restatement of prior periods. The cost of retroactively (i) making control determinations and (ii) obtaining information to prepare restated balance sheets, income statements, cash flow statements, and footnote disclosures would not outweigh the benefits.

Thank you again for the opportunity to comment. Please contact either Betsy Ellison at (212) 236-6366 or me if you have any questions or would like to discuss this topic further.

Very truly yours,

/s/ John J. Fosina

cc: Mr. Ronald Bossio, FASB Project