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## **Off Balance Sheet Entities: A Post-Implementation Look at the Effects of Interpretation 46**

### **Executive Summary**

In 2003, the FASB released Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46), which changed the requirements for consolidation of variable interest entities, previously known as special purpose entities. The interpretation was in response to the accounting scandal surrounding Enron in 2001, where off balance sheet partnerships and questionable accounting practices were utilized to hide massive amounts of debt.

The changes for consolidation set forth by FIN 46 require all public companies to reexamine their variable interest entities. As a result, many entities that were previously carried off balance sheet must now be consolidated, resulting in an increase in each company's financial leverage. Faced with a potential increase in financial leverage, companies have dealt with FIN 46 in varying ways including consolidation as required, deconsolidation, liquidation, or a restructuring of variable interest entities to avoid consolidation. This report summarizes the guidance provided in the December 2003 revision of Interpretation No. 46 and examines the effects on leverage for companies that consolidated and those that did not consolidate.

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**Georgia Tech Financial Analysis Lab**

The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, we think that independent research organizations, such as our own, have an important role to play in providing information to market participants.

Because our Lab is housed within a university, all of our research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Our focus is on issues that we believe will be of interest to a large segment of stock market participants. Depending on the issue, we may focus our attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in our work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. We define earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, our research may look into reporting practices that affect either earnings or cash flow, or both. At times our research may look at stock prices generally, though from a fundamental and not technical point of view.

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## Introduction

This report is a follow up to our report, “Off Balance Sheet Entities: A Preliminary Look at the Effects of Interpretation 46”, which was published in March 2003. In that earlier report, we summarized the guidance provided in FASB Interpretation No. 46 (FIN46), “Consolidation of Variable Interest Entities”, which was initially released in January 2003 and revised in December 2003. We also took a preliminary look at the potential financial statement impact for a sample of companies.

In this report, we revisit the effects of Interpretation 46, as revised. This report summarizes the updated guidance provided in the December 2003 revision of Interpretation 46 and identifies the results of FIN 46 on the financial statements of various companies. Specifically, we examine the effect on leverage for those companies that consolidated variable interest entities (VIEs) due to FIN 46. In addition, we examine companies who did not consolidate identified VIEs, who deconsolidated them, or who restructured them to prevent consolidation as a result of FIN 46.

## Background

A variable interest entity is so named because different parties have contractual, ownership or other financial interests in it that change with changes in the fair value of the entity's net assets. Typically, variable interest entities are established to fulfill a specific business purpose or activity. For example, such an entity may be established to hold an asset that is leased to another company, or that finances a company's customer's credit purchases. Common examples of entities or arrangements that may involve VIEs are equity method investees, leasing arrangements, securitization vehicles, and trusts.

Historically, only the company with a controlling (over 50% voting interest) equity ownership interest in another entity would consolidate it. Many VIEs had no single owner with a voting interest of more than 50%. Hence, no one consolidated them. Such treatment is proper if an entity is truly not controlled by another entity. However, FIN 46 has sought to identify entities that are effectively controlled by others.

## Summary of FASB Interpretation 46 (FIN 46)

### *Purpose of FASB Interpretation No. 46*

The purpose of FIN 46 was to clarify and especially tighten the consolidation requirements for previously unconsolidated "variable interest entities" or VIEs. These VIEs, which were formerly referred to as Special Purpose Entities, or SPEs, came to the public's attention during the Enron Corp. investigations. The company, and others, used such entities to park debt off of the balance sheet, hidden from view.

As outlined in FIN 46 as revised, the FASB's objective is to:

1. Achieve more consistent application of consolidation policies to variable interest entities, and thus, to improve comparability between enterprises engaged in similar activities.
2. Provide more complete information about the resources, obligations, risks, and opportunities of the consolidated enterprise by including the assets, liabilities, and results of the VIE activities.
3. Help financial statement users assess the enterprise's risk by requiring disclosures about variable interest entities in which an enterprise has a significant variable interest but does not consolidate.

Furthermore, the intent of FIN 46 is "not to restrict the use of variable interest entities but to improve financial reporting by enterprises involved with variable interest entities". By requiring companies to follow consistent reporting practices and requiring disclosure of previously hidden entities, the interpretation is designed to lead to more transparency where in the past much of the risk associated with VIEs was off balance sheet.

### *Variable Interest Entity*

Variable interest entities (VIEs) include many entities that have previously been referred to as special purpose entities (SPEs), but also may include many other entities not previously thought of as SPEs. VIEs include equity investments, loans, leases, derivatives, guarantees, service and management contracts, and other instruments whose values change with changes in the VIE's net assets. The initial determination of whether an entity is a variable interest is made on the date at which an enterprise becomes involved with the entity. Involvement is considered to be an ownership interest, contractual interest, or other monetary interest that may be determined to be a variable interest.

### *Primary Beneficiaries*

The enterprise that consolidates a VIE is referred to as the primary beneficiary. According to FIN 46, a VIE is to be consolidated by its primary beneficiary. A primary beneficiary of a VIE absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both.

### *Consolidation Requirements*

FIN 46 requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among the parties involved. As explained in FIN 46, VIEs are subject to consolidation if any of the following criteria are met:

1. The equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders.
2. The equity investors as a group lack one or more of the following essential characteristics of a controlling financial interest:
  - a. The direct or indirect ability to make decisions about the entity's activities through voting rights or similar rights.

- b. The obligation to absorb the expected losses of the entity.
  - c. The right to receive the expected residual returns of the entity.
3. The equity investors have voting rights that are not proportionate to their economic interests, and the activities of the entity involve or are conducted on behalf of an investor with a disproportionately small voting interest.

In summary, the consolidation requirement is effective if the VIE does not have enough of its own equity investment at risk to permit it to finance its activities without additional financial support or the holders of the equity investment at risk do not have effective control of the entity, the obligation to absorb the entity's expected losses or the right to receive its expected residual returns.

FIN 46 changed the criteria for consolidation of another entity. Previously, an entity with investment equity held by a third party of at least 3% of its total assets did not have to be consolidated. FIN 46 raised the minimum equity investment from 3% to 10%, stating, "An equity investment at risk of less than 10 percent of the entity's total assets shall not be considered sufficient to permit the entity to finance its activities..."

### *Financial Reporting*

Assts, liabilities, and noncontrolling interests of newly consolidated VIEs generally will be initially measured at their fair values except for assets and liabilities transferred to a VIE by its primary beneficiary, which will continue to be measured as if they had not been transferred. The measurement date is the date the enterprise first becomes the primary beneficiary. If recognizing those assets, liabilities, and noncontrolling interests at their fair values results in a loss to the consolidated enterprise, the loss will be reported immediately as an extraordinary item. If instead, it would result in a gain, then that amount will be allocated to reduce the amounts assigned to assets in the same manner as if consolidated resulted from a business combination. After the initial measurement, the entity is accounted for as though it were consolidated based on voting interests.

For those enterprises required to consolidate entities created before December 31, 2003, the consolidating enterprise is required to measure the assets, liabilities, and noncontrolling interests of the VIE at their carrying amount at the date the requirements of FIN 46 first apply. Carrying amounts refer to the amounts at which the assets, liabilities, and noncontrolling interests would have been carried in the consolidated financial statements if FIN 46 had been effective when the enterprise first met the conditions to be the primary beneficiary. If determining the carrying amount is not feasible, the assets, liabilities, and noncontrolling interests shall be measured at fair value at the date of application. Any difference between the net amount added to the balance sheet of the consolidating enterprise and the amounts previously recognized interest in the newly consolidated entity is accounted for as a cumulative effect of an accounting change.

### *Effective Date*

The revised version of FIN 46 is effective for fiscal years ending after December 31, 2003 if the entity was considered previously to be a SPE. If not, it is effective for all periods ending after March 15, 2004. Thus, for calendar year filers, we are seeing effective dates for the year ended December 31, 2003 or the first quarter ended March 31, 2004.

### **The Study**

In this report, we looked at companies that consolidated a variable interest entity(s) upon application of FIN 46 to determine the impact consolidation had on the company's financial leverage. For these companies, we determined the amount of assets, liabilities, and minority interests (if any) at year end attributable to the variable interest entity(s) that was consolidated as of the fiscal year end that first included the consolidated amounts. We then estimated the amount of total liabilities the company would have reported had they not consolidated the variable interest entity. Next we calculated a measure of leverage, the Debt-to-Equity ratio, for the company given its reported year end total liabilities and total shareholder's equity and compared it to an estimated Debt-to-Equity ratio using our estimated amount of liabilities had the company not consolidated the entity. We measured the Debt-to-Equity ratio using Total Liabilities and Total Shareholder's Equity as opposed to just using Long Term Debt in order to capture the entire effect of additional liabilities resulting from consolidation.

$$\text{Debt-to-Equity Ratio} = \text{Total Liabilities} / \text{Total Shareholder's Equity}$$

### **The Results**

Because consolidation results in the addition of liabilities, including debt, to the consolidating parent's balance sheet, that company will experience an increase in its Debt-to-Equity ratio, or in our measurement Total Liabilities-to-Equity ratio, as a result of FIN 46. A material increase in this measure of financial leverage could be cause for concern, as it is frequently utilized in debt covenants and other leverage assessments.

Some companies recognized the effect that consolidation would have on their debt-to-equity ratio well before their adoption of FIN 46. For example, in 2003, Home Depot reported in its 10K that as a result of FIN 46, they will record an increase in Long-Term Debt of \$282 million and Notes Receivable of \$282 million. They reported that had they consolidated these entities as of the end of fiscal 2003, the total debt-to-equity ratio would have increased from 6.1% to 7.4%.

*Companies Consolidating VIEs upon Adoption of FIN 46*

The sample of companies who reported consolidation of a previously off balance sheet variable interest entity is presented in Exhibit 1. We found that some companies did not report year end amounts for assets and liabilities that were consolidated; instead they reported the total amount consolidated upon adoption of FIN 46. We identified these companies using footnotes as shown in Exhibit 1.

Exhibit 1 provides the amount of assets and liabilities of the variable interest entity that was consolidated. In cases where there is third party ownership, minority interests (or noncontrolling interest) will also be reported in the consolidated balance sheet. For those companies who consolidated a previously held variable interest entity, the Income Statement will provide a “Cumulative Effect of Accounting Change” line item that captures the cumulative effect to income had the variable interest entity been consolidated since its inception.

**Exhibit 1: Amounts Consolidated upon Adoption of FIN 46**

Company	Fiscal YE	Assets	Liabilities	Minority Interest	Equity	Cum. Effect of Accounting Change
7-Eleven <sup>3</sup>	12/31/03	167,900,000	178,100,000			(10,200,000)
American Pacific Corp <sup>3</sup>	09/30/04	12,500,000	3,400,000		1,293,000	(769,000)
Arvinmeritor Inc <sup>3</sup>	09/30/03	50,000,000	54,000,000			(6,000,000)
BEA Systems <sup>2</sup>	01/31/04	294,600,000	211,300,000			
Cendant <sup>3</sup>	12/31/03	1,817,000,000	2,056,000,000			(293,000,000)
Dell <sup>2</sup>	01/31/04	588,000,000	588,000,000	17,000,000		
eBay <sup>2</sup>	12/31/03	126,400,000	122,500,000	3,900,000		(5,400,000)
Federal Express <sup>2</sup>	05/31/04	126,000,000	133,000,000			
Genentech <sup>2</sup>	12/31/03	348,400,000	412,300,000	12,700,000		(47,600,000)
General Electric <sup>4</sup>	12/31/03	41,563,000,000	40,007,000,000	414,000,000		(372,000,000)
General Motors <sup>3</sup>	12/31/03	4,600,000,000	4,600,000,000			(27,000,000)
Hershey Foods Corp <sup>2</sup>	12/31/03	107,700,000	115,500,000	4,400,000		(7,400,000)
International Game Technology <sup>3</sup>	09/30/04	186,600,000	186,600,000			
La-Z-Boy <sup>2</sup>	04/24/04	4,385,000	12,709,000		(8,324,000)	
Magellan Health Services <sup>2</sup>	12/31/03	43,200,000	43,200,000			
Mastercard <sup>3</sup>	12/31/03	154,000,000	149,380,000	4,620,000		
Perot Systems Corp <sup>2</sup>	12/31/03	65,200,000	75,500,000			(6,400,000)
Resource America <sup>2</sup>	09/30/03	300,924,000	186,657,000			(13,900,000)
Shaw Group <sup>2</sup>	08/31/04	39,700,000	23,500,000			
Time Warner <sup>3</sup>	12/31/03	700,000,000	700,000,000			(12,000,000)
Tyco International <sup>3</sup>	09/30/03	491,200,000	591,900,000	46,400,000		(75,100,000)
Veritas Software Corp <sup>3</sup>	12/31/03	366,800,000	369,200,000	11,400,000		(6,200,000)
Walt Disney <sup>2</sup>	09/30/04	3,925,000,000	3,608,000,000	311,000,000	6,000,000	

1 – Amounts sourced from company 10-K filings

2 – Consolidated amounts as of year end

3 – Consolidated amounts as of date of consolidation

4 – Portion of consolidated amounts reported as of year end and portion reported as of date of consolidation

Dell and Time Warner provide instructive examples of how companies consolidated their variable interest entities. Dell consolidated Dell Financial Services (DFS), for which Dell historically recorded its 70% equity interest under the equity method. Dell consolidated an equal amount of assets and liabilities, \$588 million, and recorded a minority interest of \$17 million, which it included in liabilities, that represents DFS's ownership interest. Time Warner consolidated variable interest entities that were lease-financing arrangements that were used to finance the cost of aircraft and property. The assets and liabilities that were consolidated were equal in amount at \$700 million. Time Warner also recorded a \$12 million charge, net of tax, as a "cumulative effect of accounting change" that represented cumulative losses had the VIEs been consolidated from inception.

Several companies in Exhibit 1 report a charge for the cumulative effect of accounting change resulting from adoption of FIN 46. This one time charge could be interpreted as a measure of the extent to which prior year earnings were overstated prior to consolidation.

We can also gauge the level of risk that was residing off balance sheet by examining the financial leverage impact to the company of consolidation. Our findings indicate the potential for a large percentage increase in financial leverage as a result of FIN46. Exhibit 2 presents one such measure of leverage, Total Liabilities-to-Equity, as explained earlier, calculated two different ways. The first measure (1) is based on the reported total liabilities and total shareholder's equity using balance sheet data on a consolidated basis as reported. The second measure (2) is an estimate of what the Total Liabilities-to-Equity ratio would have been had the company not consolidated the variable interest entity.

*(1) Debt-to-Equity (D/E) Ratio = Total Liabilities / Shareholder's Equity  
[represents leverage after consolidation of variable interest entities]*

*(2) Debt-to-Equity (D/E) Ratio (excluding consolidated amounts) = (Total Liabilities – Liabilities consolidated due to FIN 46) / (Shareholder's Equity – Equity consolidated due to FIN 46)  
[represents an estimate of leverage had the company not consolidated the variable interest entities]*

**Exhibit 2: Effect on Debt-to-Equity (D/E) Ratio**

Company	D/E Ratio (1)	D/E Ratio (excluding consolidated amts) (2)	% Increase in D/E Ratio due to Consolidation
7-Eleven <sup>3</sup>	8.85	8.33	6.2%
American Pacific Corp <sup>3</sup>	0.19	0.15	26.7%
Arvinmeritor Inc <sup>3</sup>	4.77	4.71	1.3%
BEA Systems <sup>2</sup>	1.29	1.07	20.6%
Cendant <sup>3</sup>	2.83	2.63	7.6%
Dell <sup>2</sup>	2.07	1.98	4.5%
eBay <sup>2</sup>	0.18	0.16	12.5%
Federal Express <sup>2</sup>	1.23	1.20	2.5%
Genentech <sup>2</sup>	0.34	0.27	25.9%
General Electric <sup>4</sup>	7.10	6.60	7.6%
General Motors <sup>3</sup>	16.74	16.56	1.1%
Hershey Foods Corp <sup>2</sup>	1.80	1.71	5.3%
International Game Technology <sup>3</sup>	0.96	0.86	11.6%
La-Z-Boy <sup>2</sup>	1.01	0.97	4.1%
Magellan Health Services <sup>2</sup>	2.32	2.21	5.0%
Mastercard <sup>3</sup>	3.15	2.93	7.5%
Perot Systems Corp <sup>2</sup>	0.42	0.31	35.5%
Resource America <sup>2</sup>	1.76	0.94	87.2%
Shaw Group <sup>2</sup>	1.28	1.26	1.6%
Time Warner <sup>3</sup>	1.05	1.04	1.0%
Tyco International <sup>3</sup>	1.41	1.39	1.4%
Veritas Software Corp <sup>3</sup>	0.51	0.40	27.5%
Walt Disney <sup>2</sup>	1.04	0.90	15.6%

1 – Any Minority Interest reported in Total Liabilities or reported separately was excluded from the Debt-to-Equity ratio calculation. Year end amounts for Assets, Liabilities, and Shareholder's Equity were utilized in the calculations.

2 – Consolidated amounts as of year end

3 – Consolidated amounts as of date of consolidation

4 – Portion of consolidated amounts reported as of year end and portion reported as of date of consolidation

The Debt-to-Equity Ratio for American Pacific, BEA Systems, Genentech, Perot Systems, Resources America, and Veritas Software increased by more than 20%. This increase in financial leverage provides one indication of the amount of off balance sheet risk that was previously “hidden” from the financial statements.

As identified by way of the footnotes in Exhibit 2, some companies reported consolidated amounts as of year end, whereas others provided consolidated amounts upon adoption of FIN 46. For those companies who reported consolidated amounts at year end, the unadjusted Debt-to-Equity ratio may not reflect the full increase in liabilities resulting from consolidation. For example, the initial debt consolidated by BEA Systems was \$325.3 million, which is more than the amount of liabilities attributed to the VIE at year end of \$211.3 million. Prior to year end, BEA Systems repaid \$114 million of long term debt related to the consolidated entity.

*Companies Not Consolidating VIEs upon Adoption of FIN 46*

We found examples of companies who upon application of FIN 46 determined that one or more entities in which they had invested were variable interest entities. However, they did not consolidate the entities because they determined that they were not the primary beneficiary. Recall that the requirement to consolidate under FIN 46 is predicated on two primary questions. First, the company must determine whether an entity is in fact a variable interest entity. Second, if the entity is a variable interest entity, the company must determine whether it is the primary beneficiary. For example, Archer Daniels Midland provided the following disclosure regarding its application of FIN 46:

“As of June 30, 2004, the Company has \$418 million of investments in private equity funds included in investments in affiliates which are considered VIEs pursuant to FIN 46. The Company’s residual risk and rewards from these VIEs are proportional to the Company’s ownership interest, and the Company is not the primary beneficiary of any of these VIEs.” (Archer Daniels Midland Co, 6/30/2004 10K)

The disclosure guidelines provided by FIN 46 state that even if an enterprise is determined not to be the primary beneficiary of a VIE, it is still required to disclose, among other requirements, the size and exposure to loss for material VIEs. Even given various requirements that must be met for consolidation provided by FIN 46, there is still opportunity for off balance sheet entities to exist. As presented in Exhibit 3, we calculated the potential effects of assumed consolidation on the Debt-to-Equity ratio for a sample of companies who *did not consolidate* one or more of their variable interest entities.

**Exhibit 3: Companies with VIEs That Were Not Consolidated**

Company	Fiscal YE	Exposure To Loss <sup>5</sup>	Assets <sup>2</sup>	Liabilities <sup>2</sup>	D/E Ratio	Est. D/E Ratio (including VIE)
Aetna	12/31/03	125,000,000	1,300,000,000	n/a <sup>3</sup>	n/a <sup>4</sup>	n/a <sup>4</sup>
Archer Daniels Midland	06/30/04	418,000,000	n/a <sup>3</sup>	n/a <sup>3</sup>	n/a <sup>4</sup>	n/a <sup>4</sup>
Dow Chemical	12/31/03	363,000,000	n/a <sup>3</sup>	n/a <sup>3</sup>	n/a <sup>4</sup>	n/a <sup>4</sup>
Ford Motor	12/31/03	229,000,000	n/a <sup>3</sup>	n/a <sup>3</sup>	n/a <sup>4</sup>	n/a <sup>4</sup>
General Motors	12/31/03	2,251,000,000	n/a <sup>3</sup>	n/a <sup>3</sup>	n/a <sup>4</sup>	n/a <sup>4</sup>
Halliburton Co	12/31/03	51,000,000	1,457,000,000	1,455,000,000	5.03	5.60
La-Z-Boy	04/24/04	n/a <sup>3</sup>	15,000,000	15,000,000	1.01	1.03
Monsanto	08/31/04	23,000,000	55,000,000	28,000,000	0.74	0.75
Paychex	05/31/04	6,100,000	n/a <sup>3</sup>	n/a <sup>3</sup>	n/a <sup>4</sup>	n/a <sup>4</sup>
Shaw Group	08/31/04	8,800,000	37,200,000	13,700,000	1.28	1.30
Vail Resorts Inc	07/31/04	20,900,000	223,700,000	172,500,000	2.05	2.40

<sup>1</sup> – Any Minority Interest reported in Total Liabilities or reported separately was excluded from the Debt-to-Equity ratio calculation. Year end amounts for Assets, Liabilities, and Shareholder’s Equity were utilized in calculations.

<sup>2</sup> – These amounts represent our estimate of the increase in assets and liabilities if the entity(s) were to be consolidated. These amounts were taken from the disclosures provided in the company’s 10K.

<sup>3</sup> – The amount was not disclosed in the company’s 10K.

<sup>4</sup> – Calculation could not be determined due to lack of disclosure liabilities associated to the VIE.

<sup>5</sup> – These amounts represent were taken from the disclosures pertaining to exposure to loss related to variable interest entities provided in the company’s 10K.

The exposure to loss reported by companies in Exhibit 3 represents the equity investment in the VIE that resides on the balance sheet of the company or can represent the amount that the company has guaranteed on behalf of the VIE. For example, Aetna disclosed that its “maximum exposure to loss as a result of its investment in these partnerships is its investment balance at December 31, 2003 of approximately \$125 million”. The investment balance Aetna is referring to is its equity investment in the VIE. Dow Chemicals reported that it “provided to the owner trust a residual value guarantee of \$363 million, which represents Dow's maximum exposure to loss” under the lease agreement between it and the VIE. For those companies where sufficient disclosure of VIE assets and liabilities were available, the Debt-to-Equity ratio would have increased for each company had they consolidated the VIE. Other companies, such as Toro and Walt Disney reported the existence of VIEs for which they were not the primary beneficiary; however, the exposure to loss and assets and liabilities of the VIE were not disclosed due to lack of material transactions or material exposure.

### *Companies Deconsolidating VIEs upon Adoption of FIN 46*

We also identified some companies who actually deconsolidated existing variable interest entities due to the adoption of FIN 46. Companies who deconsolidated did so upon determining that they were not the primary beneficiary as defined by FIN 46. For example, International Paper provided the following disclosure related to their application of FIN 46.

“As a result of the application of the provisions of FIN 46(R) during 2003, four entities that were required to be consolidated under prior accounting rules were deconsolidated, and one previously unconsolidated entity was consolidated, at December 31, 2003.” (International Paper Co., 12/31/03 10K)

Among other reasons cited for deconsolidation of a previously consolidated entity relate to the revised requirements between FIN46 and FIN46R. For example, AGL Resources consolidated a trust under FIN46 at fiscal year end 2003 (12/31/03) upon determination that they were the primary beneficiary; however, at fiscal year end 2004 (12/31/04), AGL Resources deconsolidated the same trust based on guidance provided by FIN46R as described further in their FIN 46 disclosure.

“The revisions in FIN 46R included specific guidance that instruments such as the call options included in our loan agreements with the Trusts do not constitute variable interests and should not be considered in the determination of the primary beneficiary. As a result, as of January 1, 2004 (when we adopted FIN 46R), we were required to exclude the accounts of the Trusts from our consolidated financial statements and to classify amounts payable to the Trusts as “Notes payable to Trusts” within long-term debt in our consolidated balance sheets as of December 31, 2004.” (AGL Resources, 12/31/04 10K)

In 2004, upon adoption of FIN46R, Tyco International also deconsolidated four joint ventures that were consolidated in the prior year upon adoption of FIN46. Tyco, however, does not state what specific characteristic of the joint ventures led them to deconsolidate under the revised requirements.

“FIN 46R further explains how to identify Variable Interest Entities and how to determine when a business enterprise should include the assets, liabilities, noncontrolling interest and results of VIE in its financial statements. The Company adopted FIN 46R as of March 31, 2004. As a result, the

joint ventures that were previously consolidated under FIN 46 were deconsolidated effective March 31, 2004.” (Tyco International, 09/30/04 10K)

### *Companies Who Restructured to Prevent Consolidation upon Adoption of FIN 46*

Some companies took steps to mitigate or prevent the financial statement effects of FIN 46. Our study identified companies that implemented varying methods, including liquidation of the variable interest entity or restructuring it, so that consolidation would not be required.

The following companies restructured leases in order to maintain off-balance sheet status under FIN46:

#### **Human Genome Sciences Inc:**

“In order to comply with the requirements of FIN 46, the Company restructured the lease relating to the Traville site in June 2003 and entered into an approximately seven year operating lease with WDC. WDC, a wholly-owned subsidiary of Wachovia Corporation, is primarily engaged in real estate finance, development and leasing activities.....As of December 31, 2003, the total financed cost of the Traville facility relative to WDC’s total direct real estate investments and net real estate lease investments was below the level requiring consolidation of WDC into the Company’s consolidated financial statements” (Human Genome Sciences Inc, 12/31/03 10K)

#### **Tyco International:**

“During 2003, the Company adopted FIN 46 and, accordingly, restructured one of the synthetic leases to meet the requirements of FIN 46 for off-balance sheet accounting.” (Tyco International, 09/30/04 10K)

#### **ChoicePoint:**

“During 2003, we modified our \$48 million synthetic lease to, among other things, continue to qualify for off-balance sheet treatment in accordance with the provisions of Financial Accounting Standards Board Interpretation No. 46...If the Company had elected to purchase the properties instead of entering into the synthetic leases, total assets and debt would have increased by \$67.3 million at December 31, 2003...” (ChoicePoint, 12/31/03 10K)

#### **Pep Boys Manny Moe & Jack:**

“The adoption of FIN 46 will apply to the \$132,000,000 of real estate leased by the Company under its \$143,000,000 operating lease facility, which would qualify as a variable interest entity under this interpretation. If this operating lease facility exists as of August 3, 2003, the Company would consolidate this entity and record a liability of \$132,000,000 and the corresponding assets, net of accumulated depreciation. The Company is planning to refinance this facility prior to August 3, 2003, so that it is not required to consolidate this entity under FIN 46.” (Pep Boys Manny Moe & Jack, 05/02/03 10K)

“On August 1, 2003 the Company refinanced its real estate operating lease facility, which qualified as a variable interest entity, into a new entity. The Company evaluated this leasing transaction in accordance with the original guidance of FIN 46 and determined it does not have to consolidate this leasing entity.” (Pep Boys Manny Moe & Jack, 01/31/04 10K)

In 2003, Petsmart also indicated that it would potentially restructure a lease so as not to require consolidation, however, in 2004, the potential VIE instead was liquidated.

“As currently constituted, our structured lease financing facilities may involve a variable interest entity of which we are the primary beneficiary. If so determined, we would be required to consolidate the seven stores and two properties at the beginning of the third quarter of fiscal 2003, which would increase fixed assets and debt by \$27.7 million, and also have an impact on depreciation expense. However, we may be able to restructure these leases so as not to require consolidation.” (Petsmart, 02/02/03 10K)

“In 2003, we purchased two properties from the structured lease financing facility, and based on current appraisals, we recorded a \$1.7 million loss in the consolidated financial statements. Subsequent to this purchase and also in 2003, the structured lease financing facility was liquidated and the remaining seven stores were leased by the Company...With the liquidation of our special purpose entity during 2003, FIN 46 did not have a material impact on our consolidated financial statements.” (Petsmart, 02/01/04 10K)

Had these companies not restructured or liquidated their VIEs, they also could have experienced a negative impact to its Debt-to-Equity ratio due to the additional liabilities that would be brought onto the balance sheet. For example, Pep Boys reported that its liabilities would have increased by \$132 million, which would have caused its D/E ratio to increase from 1.99 to 2.21. Petsmart reported that its liabilities would have increased by \$27.7 million, which would have caused its D/E ratio to increase from 0.64 to 0.67.

## Conclusion

FASB Interpretation No. 46 has provided a much needed source of information pertaining to a company's off-balance sheet activities. As indicated by our sample in Exhibit 1, many companies were impacted by the new model for consolidation. The consolidation and related disclosures not only provide more transparency for financial statement readers, but also allow analysts to obtain a more accurate measure of a company's risk as measured by its Debt-to-Equity ratio. The samples analyzed indicate a wide ranging impact to the Debt-to-Equity ratio of various companies. Most experienced a small to moderate increase in the leverage ratio, however, some experienced large increases.

We found varying degrees of disclosure and implementation of FIN 46. Ideally, in instances where a company determines that an entity is a VIE and determines that it is the primary beneficiary, consolidation would take place. However, faced with a potential increase in the Debt-to-Equity ratio, companies took various steps to avoid or mitigate the effects of consolidation. For example, some companies liquidated or restructured their variable interest entities to avoid consolidation where others paid down consolidated liabilities prior to release of their financial statements.