

Financial Analysis: A User Approach
Chapter 8
Accounting Analysis: Specific Issues 1

Last chapter we introduced the idea that analysis should not blindly use reported accounting information, but should instead consider the potential for earnings management via aggressive revenue recognition and cookie-jar reserves. In this chapter we will begin to consider several specific accounting issues that should be considered as you review financial statements and perform analysis.

Marketable Securities

Companies have a variety of motives that lead them to invest in marketable securities. Generally the motives are either return or influence/control. When a company reaches a level of investment that results in influence/control (generally greater than 20% of the outstanding equity) the equity method is used. When the investment is in debt securities and when the influence is nominal (<20% ownership) the accounting treatment is based on the type of security and the intent of management.

Classification	Type of Security	Cost of FV?	FV Changes Reported in?
Held-to-maturity	Debt securities purchased with both the intent and ability to hold until maturity	Cost	N/A
Trading	Debt and Equity securities that management purchases for short term gains	Fair Value	Unrealized holding gains and losses reported in net income
Available	Debt and Equity Securities not classified as HTM or Trading	Fair Value	Unrealized holding gains and losses reported as Other Comprehensive Income

In addition to debt and equity investments many companies will report cash and cash equivalents. Cash equivalents are short-term, highly liquid investments that have both of the following characteristics:

- Readily convertible to known amounts of cash
- So near their maturity that they present insignificant risk of changes in value because of changes in interest rates

Generally, only investments with original maturities of three months or less qualify under that definition.

Excerpt from the STX 10-K

Cash, Cash Equivalents and Short-Term Investments—The Company considers all highly liquid investments with a remaining maturity of 90 days or less at the time of purchase to be cash equivalents. Cash equivalents are carried at cost, which approximates fair value. The Company's short-term investments are primarily comprised of readily marketable debt securities with remaining maturities of more than 90 days at the time of purchase. The Company has classified its entire investment portfolio as available-for-sale. Available-for-sale securities are classified as cash equivalents or short-term investments and are stated at fair value with unrealized gains and losses included in accumulated other comprehensive income (loss), which is a component of shareholders' equity. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization and accretion are included in interest income. Realized gains and losses are included in other income (expense). The cost of securities sold is based on the specific identification method. The Company invests in auction rate securities. As of June 30, 2006 and June 29, 2007, auction rate securities that had stated maturities greater than three months were classified as short-term investments unless they were purchased three months or less from contractual maturity. As of June 27, 2008, the Company reclassified all auction rate securities to long-term investments due to failed auctions (see Note 2).

Financial Instruments

The following is a summary of the fair value of available-for-sale securities at June 27, 2008 (in millions):

	Amortized	Unrealized	Fair
	Cost	Gain/	Value
US Government & Agency	\$ 120	\$ (1)	\$ 119
Asset Backed Securities	16	—	16
Corporate Bonds	18	—	18
Municipal Bonds	2	—	2
Auction Rate Securities	31	(3)	28
Commercial Paper	333	—	333
Bank Time Deposits	28	—	28
Money Market	546	—	546
Total	\$ 1,094	\$ (4)	\$ 1,090
Included in cash and cash equivalents			\$ 911
Included in short term investments			151
Included in long term investments			28
			\$ 1,090

At June 27, 2008, the Company had no marketable securities that had been in a continuous unrealized loss position for a period greater than 12 months and determined no investments were other-than-temporarily impaired.

The fair value of the Company's investment in debt securities, by remaining contractual maturity, is as follows (in millions):

	June 27,	June 29,
Due in less than 1 year	\$ 432	\$ 916
Due in 1 to 3 years	85	27
	\$ 517	\$ 943

Fair Value Disclosures—The carrying value of cash equivalents approximates fair value. The fair values of short-term investments, debentures, notes and loans are estimated based on quoted market prices as of June 27, 2008.

The carrying values and fair values of the Company's financial instruments are as follows:

	June 27, 2008		June 29, 2007	
	Carrying	Estimated	Carrying	Estimated
			(In millions)	
Cash equivalents	\$ 911	\$ 911	\$ 862	\$ 862
Short-term investments	151	151	157	156
Long-term investments	28	28	—	—
Floating Rate Senior Notes due October 2009	(300)	(293)	(300)	(300)
6.375% Senior Notes due October 2011	(599)	(584)	(599)	(588)
6.8% Senior Notes due October 2016	(599)	(555)	(598)	(577)
6.8% Convertible Senior Notes due April 2010	(135)	(142)	(135)	(145)
5.75% Subordinated Debentures due March 2012	(41)	(40)	(45)	(45)
2.375% Convertible Senior Notes due August 2012	(326)	(422)	(326)	(455)
LIBOR Based China Manufacturing Facility Loan	(30)	(30)	(60)	(60)

The fair value of the Company's 2.375% and 6.8% convertible securities is a function, in part, of the Company's stock price. Because the Company's stock price has decreased since June 27, 2008, the fair value of these securities has also decreased.

Investment Securities—As of June 27, 2008, the Company held auction rate securities in the amount of \$31 million, all of which are collateralized by pools of student loans guaranteed by the Federal Family Education Loan Program. During the fiscal 2008 year, these securities failed to settle at auction and as a result the Company recorded an unrealized loss of \$3 million and reclassified the securities to long-term investments.

Inventory

Several different accounting methods are available to compute the value of Ending Inventories and the Cost of Goods Sold. The most common methods chosen are:

- LIFO – must be used when LIFO is used on your tax return (LIFO conformity rule) – appropriate for companies that face inflationary input prices (inputs contain energy and labor costs that are increasing across time)
- FIFO – typically used by companies that face deflationary price streams (e.g. technology companies)
- Average Cost – typically used by companies that do not have a consistent pattern of input price movements

Additional Details:

- Inventory accounting methods are largely based on tax considerations
- Companies can use different methods for different categories of inventory
- If a company uses LIFO they must disclose in their footnotes the current replacement cost (which approximates FIFO). As a result if you are performing a comparison of companies that use different methods (LIFO/FIFO) adjustments can be made
- Regardless of method used to determine cost, all companies must apply the lower-of-cost-or-market rule to assess potential obsolescence

From the STX 10-K

Inventory—Inventories are valued at the lower of cost (which approximates actual cost using the first-in, first-out method) or market. Market value is based upon an estimated average selling price reduced by estimated cost of completion and disposal.

Inventories

Inventories are summarized below:

	June 27, 2008	June 29, 2007
	(In millions)	
Raw materials and components	\$ 352	\$ 277
Work-in-process	111	85
Finished goods	482	432
	<u>\$ 945</u>	<u>\$ 794</u>

Fixed Assets (Property, Plant, and Equipment)

PP&E accounting involves accounting method choice (Straight-Line, Double Declining Balance, etc.) and management estimates (estimated useful life, salvage value, impairment assessment)

You are not required to use the same method for your financial statements that you use on your tax return, in fact, MACRS (modified accelerated cost recovery system) is used on tax returns.

Often tax methods permit deductions on the tax return earlier in the asset's life when compared to the method used for financial reporting. This is offset later in the asset's life with smaller amounts on the tax return when compared the financial statement amounts. (Think straight line method on the books and accelerated depreciation on the tax return.) This difference will create deferred taxes on the financial statements.

While typically only Net PP&E is reported in the financial statements, companies are required to report gross PP&E (original cost) and accumulated depreciation in their footnotes. These disclosures support the following computations:

Ratio	Calculation
Average Asset Age	= Accumulated Depreciation/Depreciation Expense
Average Age %	= Accumulated Depreciation/Ending Gross PP&E
Average Depreciable Life	= Ending Gross PP&E/Depreciation Expense

From the STX 10-K

Property, equipment and leasehold improvements, net

Property, equipment and leasehold improvements consisted of the following:

	Useful Life in Years	June 27, 2008	June 29, 2007
(In millions)			
Land		\$ 21	\$ 21
Equipment	3-5	4,404	4,004
Building and leasehold improvements	Life of lease -48	992	731
Construction in progress		428	348
		<u>5,845</u>	<u>5,104</u>
Less accumulated depreciation and amortization		(3,381)	(2,826)
		<u>\$ 2,464</u>	<u>\$ 2,278</u>

Amortization of leasehold improvements is included in depreciation and amortization expense.

Depreciation and amortization expense was \$844 million, \$851 million and \$612 million for fiscal years 2008, 2007 and 2006, respectively.

From WDC 10-K

	Years Ended	
	June 27, 2008	June 29, 2007
	(in millions)	
Property and Equipment:		
Land and buildings	\$ 478	\$ 189
Machinery and equipment	2,166	1,203
Machinery and equipment recorded under capital leases	58	60
Furniture and fixtures	10	12
Leasehold improvements	102	53
	2,814	1,517
Accumulated depreciation and amortization	(1,146)	(776)
Net property and equipment	\$ 1,668	\$ 741

Amortization expense for assets under capital lease was \$12 million, \$14 million and \$5 million for 2008, 2007 and 2006, respectively. Accumulated amortization on machinery and equipment recorded under capital leases was \$30 million and \$20 million as of June 27, 2008 and June 29, 2007, respectively. Total Depreciation and Amortization for 2008 was \$413.

	STX	WDC
Dep. Exp.	\$844	\$413
Gross PPE	\$5,845	\$2,814
Acc. Dep.	\$3,381	\$1,146
Average Asset Age	4.00 Years	2.77 Years
Average Age %	57.8%	40.7%
Average Depreciable Life	6.92 Years	6.81 Years

Income Tax

Financial reporting and tax reporting are based on different agendas. Financial reporting methods are designed to report performance and assets/claims to assets. Tax reporting methods are designed to raise revenue for the government and incent/disincent certain behaviors. As a result, book income (pretax income based on the financial accounting method) and taxable income (the amount used to determine your tax liability) will almost always be different. As a consequence of these differences, deferred taxes are used to reconcile the difference between tax expense (roughly based on book income) and taxes payable (based on taxable income).

Specifically deferred taxes are used to accounting for timing differences between book and tax methods (revenue/expense reported in different periods). Alternatively, deferred taxes are not required for permanent differences (differences that do not reverse).

Example - Deferred Tax Liability

A company purchases a machine for \$400 and depreciates it using the following schedule:

	Books	Tax
Year 1	200	300
Year 2	200	100
Total	400	400

Assuming a 40% tax rate and \$1,000 of book income before tax for both years the following entries would be recorded.

Year	Accounts	Debit	Credit
1	Income Tax Expense	400	
	Deferred Tax Liability		40
	Income Tax Payable		360
2	Income Tax Expense	400	
	Deferred Tax Liability	40	
	Income Tax Payable		440

Example – Deferred Income Tax Asset

A firm leased unused space in its warehouse collecting \$400 rent for two years. The lease required the rent to be paid in advance.

	Books	Tax
Year 1	200	400
Year 2	200	0
Total	400	400

Assuming a 40% tax rate and \$1,000 of book income before tax for both years the following entries would be recorded.

Year	Accounts	Debit	Credit
1	Income Tax Expense	400	
	Deferred Tax Asset	80	
	Income Tax Payable		480
2	Income Tax Expense	400	
	Deferred Tax Asset		80
	Income Tax Payable		320

Deferred tax assets can also arise from net operating loss carryforwards.

Substantial disclosures are required related to income taxes. These include:

- Calculation of the effective tax rate and an explanation of the sources of differences between the enacted rate and the effective rate
- Sources and amounts of deferred tax assets and deferred tax liabilities

FIN 48R has been a controversial change in the reporting of income taxes. Under this guidance companies must accrue deferred taxes if in their option, under a more-likely-than-not standard, they would be subject to additional tax if an aggressive tax position were to be challenged by the relevant taxing authority.

Ratio	Calculation
Taxes Payable Rate	= Current Income Tax Expense/Pretax Income
Taxes Paid Rate	= Cash Paid for Income Taxes/Pretax Income

From the STX 10-K

Income Taxes

The provision for (benefit from) income taxes consisted of the following:

	Fiscal Years Ended		
	June 27,	June 29,	June 30,
		(In millions)	
Current Tax Expense (Benefit):			
U.S. Federal	\$ 8	\$ 6	\$ 35
U.S. State	10	(1)	7
Foreign	26	8	19
Total Current	<u>\$ 44</u>	<u>\$ 13</u>	<u>\$ 61</u>
Deferred Tax Expense (Benefit):			
U.S. Federal	\$ 34	\$ (319)	\$ 29
U.S. State	3	(40)	4
Foreign	(14)	(6)	(10)
Total Deferred	<u>\$ 23</u>	<u>\$ (365)</u>	<u>\$ 23</u>
Provision for (Benefit from) income taxes	<u>\$ 67</u>	<u>\$ (352)</u>	<u>\$ 84</u>

Income before income taxes consisted of the following:

	Fiscal Years Ended		
	June 27,	June 29,	June 30,
		(In millions)	
U.S.	\$ 90	\$ (125)	\$ (18)
Foreign	1,239	686	942
	<u>\$ 1,329</u>	<u>\$ 561</u>	<u>\$ 924</u>

For fiscal year 2008 there were \$6 million tax benefits recorded to Additional Paid-In Capital associated with stock option deductions. The Company did not record a tax expense associated with stock option deductions in fiscal year 2007 compared to \$44 million recorded in fiscal year 2006; the related tax benefit was recorded directly to Additional Paid-In Capital.

U.S. federal and state deferred tax expense in fiscal year 2008 was \$37 million. In fiscal year 2007, the deferred tax benefit of \$359 million includes \$319 million of deferred tax benefits resulting from the release of valuation allowance recorded in prior years. The fiscal year 2007 valuation allowance release was largely due to the completion during 2007 of the restructuring of the Company's intercompany arrangements, which enables the Company to forecast future U.S. taxable income with greater certainty and U.S. taxable income from the intercompany sale of certain Maxtor assets. This 2007 valuation allowance release also included a reduction of \$322 million in Maxtor goodwill required as a result of the reversal of valuation allowance previously recorded as of the acquisition date against Maxtor related deferred tax assets primarily for tax net operating loss carryovers.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The significant components of the Company's deferred tax assets and liabilities were as follows:

	June 27, 2008	June 29, 2007
	(In millions)	
Deferred Tax Assets		
Accrued warranty	\$ 156	\$ 129
Inventory valuation accounts	44	32
Receivable reserves	15	22
Accrued compensation and benefits	139	119
Depreciation	166	185
Restructuring allowance	13	16
Other accruals and deferred items	110	115
Net operating losses and tax credit carry-forwards	585	436
Capitalized research and development	29	32
Other assets	13	12
Total Deferred Tax Assets	<u>1,270</u>	<u>1,098</u>
Valuation allowance	(433)	(399)
Net Deferred Tax Assets	<u>837</u>	<u>699</u>
Deferred Tax Liabilities		
Unremitted earnings of certain foreign entities	(4)	(5)
Acquired intangible assets	(25)	(31)
Total Deferred Tax Liabilities	<u>(29)</u>	<u>(36)</u>
Net Deferred Tax Assets/(Liabilities)	808	663
Deferred taxes on Inter-company transactions	82	105
Total Deferred Tax Assets	<u>\$ 890</u>	<u>\$ 768</u>
As Reported on the Balance Sheet		
Current assets—Deferred Income taxes	\$ 274	\$ 196
Non-current assets—Deferred Tax Assets	616	574
Other non-current liabilities	—	(2)
Total Deferred Income Taxes	<u>\$ 890</u>	<u>\$ 768</u>

As of June 27, 2008, the deferred tax asset valuation allowance recorded was \$433 million. Approximately \$22 million of this amount relates to deferred tax assets acquired in the Maxtor transaction for which the related benefit will be credited directly to goodwill when and if realized. The net increase in the valuation allowance in fiscal year 2008 was \$34 million. In fiscal years 2007 and 2006, the valuation allowance decreased by \$580 million and increased by \$327 million, respectively. The fiscal year 2007 valuation allowance release was largely due to the completion during 2007 of the restructuring of the Company's intercompany arrangements, which enables the Company to forecast future U.S. taxable income with greater certainty and U.S. taxable income from the intercompany sale of certain Maxtor assets.

At June 27, 2008, the Company had recorded \$890 million of net deferred tax assets. The realization of \$808 million of these deferred tax assets is primarily dependent on the Company's ability to generate sufficient U.S. and certain foreign taxable income in future periods. Although realization is not assured, the Company's management believes that it is more likely than not these deferred tax assets will be realized. The amount of deferred tax assets considered realizable, however, may increase or decrease, when the Company reevaluates the underlying basis for its estimates of future U.S. and certain foreign taxable income.

At June 27, 2008, the Company had U.S. federal, state and foreign tax net operating loss carryforwards of approximately \$2 billion, \$896 million and \$690 million, respectively, which will expire at various dates beginning in 2009 if not utilized. At June 27, 2008, the Company had U.S. federal and state tax credit carryforwards of \$238 million and \$87 million, respectively, which will expire at various dates beginning in 2009, if not utilized. These net operating losses and tax credit carryforwards have not been audited by the relevant tax authorities and could be subject to adjustment on examination. Of the \$2 billion of loss carryovers noted above, approximately \$859 million will be credited to Additional Paid-in Capital upon recognition.

As a result of the Maxtor acquisition, Maxtor underwent a change in ownership within the meaning of Section 382 of the Internal Revenue Code (IRC Sec. 382) on May 19, 2006. In general, IRC Section 382 places annual limitations on the use of certain tax attributes such as net operating losses and tax credit carryovers in existence at the ownership change date. As of June 27, 2008, approximately \$1.3 billion and \$337 million of U.S. federal and state net operating losses, respectively, and \$36 million of tax credit carryovers acquired from Maxtor are generally subject to an annual limitation of approximately \$110 million. Certain amounts may be accelerated into the first five years following the acquisition pursuant to IRC Section 382 and published notices.

On January 3, 2005, the Company underwent a change in ownership under IRC Section 382 due to the sale of common shares to the public by its then largest shareholder, New SAC. Based on an independent valuation as of January 3, 2005, the annual limitation for this change is \$44.8 million. As of June 27, 2008, there is \$453 million of U.S. net operating loss carryforwards and \$110 million of U.S. tax credit carryforwards subject to IRC Section 382 limitation associated with the January 3, 2005 change. To the extent management believes it is more likely than not that the deferred tax assets associated with tax attributes subject to IRC Section 382 limitations will not be realized, a valuation allowance has been provided.

The applicable statutory rate in the Cayman Islands was zero for the Company for fiscal years ended June 27, 2008, June 29, 2007 and June 30, 2006. For purposes of the reconciliation between the provision for (benefit from) income taxes at the statutory rate and the effective tax rate, a notional U.S. 35% rate is applied as follows.

	Fiscal Years Ended		
	June 27,	June 29,	June 30,
	(In millions)		
Provision at U.S. notional statutory rate	\$ 465	\$ 196	\$ 323
State income tax provision (benefit), net of U.S. notional income tax benefit	12	(41)	7
Permanent differences	10	14	13
Valuation allowance	(41)	(279)	65
Use of current year U.S. tax credit	(1)	(27)	(11)
Foreign earnings not subject to U.S. notional income tax	(406)	(227)	(309)
Tax expense related to intercompany transactions	24	19	—
Other individually immaterial items	4	(7)	(4)
Provision for (benefit from) income taxes	<u>\$ 67</u>	<u>\$ (352)</u>	<u>\$ 84</u>

A substantial portion of the Company's manufacturing operations in China, Malaysia, Singapore, Switzerland and Thailand operate under various tax holidays and tax incentive programs, which expire in whole or in part at various dates through 2020. Certain of the tax holidays may be extended if specific conditions are met. The net impact of these tax holidays and tax incentive programs was to increase the Company's net income by approximately \$214 million in fiscal year 2008 (\$0.40 per share, diluted), \$194 million in fiscal year 2007 (\$0.33 per share, diluted), and \$197 million in fiscal year 2006 (\$0.38 per share, diluted).

The Company consists of a foreign parent holding company with various foreign and U.S. subsidiaries. Dividend distributions received from the Company's U.S. subsidiaries may be subject to U.S. withholding taxes when, and if, distributed. Deferred tax liabilities have not been recorded on unremitted earnings of certain other foreign subsidiaries, as these earnings will not be subject to tax in the Cayman Islands or U.S. federal income tax if remitted to the foreign parent holding company.

Effective at the beginning of the first quarter of fiscal year 2008, the Company adopted the provisions of FIN 48. FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement.

As a result of the implementation of FIN 48, the Company increased its liability for net unrecognized tax benefits at the date of adoption. The Company accounted for the increase primarily as a cumulative effect of a change in accounting principle that resulted in a decrease to retained earnings of \$3 million and an increase to goodwill of \$25 million. The total amount of gross unrecognized tax benefits as of the date of adoption was \$385 million excluding interest and penalties. At June 27, 2008, the Company had approximately \$374 million in total unrecognized tax benefits excluding interest and penalties. The total unrecognized tax benefits that, if recognized, would impact the effective tax rate were \$63 million and \$75 million as of June 29, 2007 and June 27, 2008, respectively.

	2008	2007
Current Income Tax Expense	44	13
Cash Paid for Income Tax*	34	38
Pretax Income	1,329	561
Taxes Payable Rate	3.31%	2.31%
Taxes Paid Rate	2.56%	6.77%

* From SCFs

Leases

Leases present a challenging accounting issue because they include two, substantially different, categories of transactions:

- Renting an asset for a short period of time
- Purchasing an asset and financing the purchase through the lease payments
- Operating Leases treatment is used when you are renting an asset
- Capital Lease treatment is used when you are purchasing/financing an asset via a lease

In order to determine if a lease is capital or operating a four factor test is applied to the lease at inception. If none of these factors is present in the lease then operating treatment is allowed. If any one of these factors is present then capital lease treatment is required.

For the noncancellable portion of the lease:

- Does title to the asset transfer at the end of the lease?
- Is there a bargain purchase option?
- Is the lease term 75% or more than the economic life of the asset?
- Is the present value of the minimum lease payments 90% or more than the fair market value of the asset?

As you can imagine many leases are carefully crafted to achieve operation lease treatment.

Event	Operating Lease	Capital Lease
At lease inception	No entry required	Leased Asset Lease Obligation
Each period during the life of the lease	Rent Expense Cash	Interest Expense Lease Obligation Cash Depreciation Expense Accumulated Deprec.

Because no asset or liability is reported for operation leases this is referred to off-balance sheet financing.

Note – difference in the manner that companies have acquired their PP&E (purchase, capital lease, operating lease) can make comparisons difficult. There are methods to capitalize operating leases which offer a potential solution.

Lease accounting is considered the poster child for the problems of a rules-based approach. The IASB answer was to develop a principles-based approach (if the substantial benefits and risks of ownership are transferred via the lease then capitalize, otherwise treat as operating) which exposes the limitations of that type of solution. Both the FASB and IASB seem to be ready to tackle the issue again. A new approach will probably capitalize everything but that will have to wait until the economy recovers as it will move trillions of liabilities onto balance sheets.

From the STX 10-K

8. Commitments

Leases—The Company leases certain property, facilities and equipment under non-cancelable lease agreements. Land and facility leases expire at various dates through 2082 and contain various provisions for rental adjustments including, in certain cases, a provision based on increases in the Consumer Price Index. Also, certain leases provide for renewal of the lease at the Company's option at expiration of the lease. All of the leases require the Company to pay property taxes, insurance and normal maintenance costs.

Future minimum lease payments for operating leases with initial or remaining terms of one year or more were as follows at June 27, 2008 (lease payments are shown net of sublease income):

Fiscal Years Ending	Operating
	(In millions)
2009	\$ 42
2010	38
2011	39
2012	34
2013	20
Thereafter	108
	\$ 281

Total rent expense for all land, facility and equipment operating leases was approximately \$32 million, \$36 million and \$24 million for fiscal years 2008, 2007 and 2006, respectively. Total sublease rental income for fiscal years 2008, 2007 and 2006 was \$6 million, \$11 million and \$6 million, respectively. The Company subleases a portion of its facilities that it considers to be in excess of current requirements. As of June 27, 2008, total future lease income to be recognized for the Company's existing subleases is approximately \$26 million.

Special Purpose Entities (SPEs)

A special purpose entity (SPE) is a legal entity created to fulfill narrow, specific or temporary objectives.

Negative Examples – Enron's use of SPEs to hide losses and debt

Positive Examples – Sale of assets (buildings, receivables, into a bankruptcy-remote entity)

Subsequent to Enron the FASB released FIN 46 which created a new entity called a Variable Interest Entity (VIE). A VIE refers to an entity (the investee) in which the investor holds a controlling interest which is not based on the majority of voting rights. The importance of identifying a VIE is that companies need to consolidate such entities if it is the primary beneficiary of the VIE.

A VIE is an entity meeting one of the following three criteria:

- The equity-at-risk is not sufficient to support the entity's activities (e.g.: the entity is thinly capitalized, the group of equity holders possess no substantive voting rights, etc.);
- As a group, the equity-at-risk holders cannot control the entity; or
- The economics do not coincide with the voting interests (commonly known as the "anti-abuse rule").