

Note: These materials are provided to facilitate understanding of the issues to be addressed at PCFRC meetings. These materials are presented for discussion purposes only; they are not intended to reflect the views of the FASB, AICPA, or their staff. Official positions of the FASB are determined only after extensive due process and deliberations.

Power Service Stations, Inc. (the Company), which is owned by brothers John and Robert Smith and is taxed under Subchapter S of the Internal Revenue Code, operates 21 service stations located in the northeast United States. The Company owns 16 of the service stations and hires five service station locations from JR Investments, Ltd. (JR).

John and Robert Smith designed and formed JR in 19XX for risk-management purposes and to facilitate different levels of investment by the two brothers. John and Robert Smith are limited partners of JR and, together, own 99% of JR; the Company owns 1% of JR and is the general partner of JR. As a condition for obtaining a loan to finance the acquisition of the five service stations, the bank required a guarantee, which was provided by the Company. (JR has not guaranteed, or pledged its assets as collateral for, the obligations of the Company.) Letting the five service stations to the Company under operating leases is JR's sole business activity.

Prior to the effective date of FIN 46(R), *Consolidation of Variable Interest Entities*, the Company accounted for its investment in JR using the equity method. Under FIN 46(R), however, the company is deemed to control JR and is required to consolidate the assets, liabilities, and noncontrolling interest in JR.

Following are two sets of financial statements. The first set (Exhibit 1) illustrates what the Company's financial statements would have looked like had FIN 46(R) not been applicable to the financial statements of privately held companies. The second set (Exhibit 2) are the Company's actual financial statements, in which JR is consolidated in accordance with FIN 46(R). Both exhibits include only selected note disclosures.

POWER SERVICE STATIONS, INC.
BALANCE SHEET
DECEMBER 31, 2006

Assets	
Current assets	
Cash	\$ 2,225,471
Accounts receivable	2,333,853
Inventories	1,584,952
Prepaid expenses	<u>247,085</u>
Total current assets	6,391,361
Property, plant and equipment (at depreciated cost)	<u>8,620,794</u>
Other assets	
Accounts receivable – related party	83,889
Investment in limited liability entity	38,702
Unamortized loan costs	<u>23,213</u>
Total other assets	<u>145,804</u>
Total assets	<u>\$ 15,157,959</u>
Liabilities and stockholders equity	
Current liabilities	
Accounts payable	\$ 2,805,483
Accrued taxes	582,745
Accrued expenses	379,292
Current maturities of long-term debt	<u>1,107,445</u>
Total current liabilities	4,874,965
Long-term liabilities	
Noncurrent maturities of long-term debt	<u>3,953,861</u>
Total liabilities	<u>8,828,826</u>
Stockholders equity	
Capital stock	25
Additional paid-in capital	60,767
Retained earnings	<u>6,268,341</u>
Total stockholders equity	<u>6,329,133</u>
Total liabilities and stockholders equity	<u>\$ 15,157,959</u>

The accompanying notes are an integral part of these financial statements.

POWER SERVICE STATIONS, INC.
 STATEMENT OF INCOME
 FOR THE YEAR ENDED DECEMBER 31, 2006

Sales	<u>\$104,146,932</u>
Cost of sales	
Beginning inventories	1,558,371
Purchases	<u>92,421,657</u>
	93,980,028
Ending inventories	<u>(1,584,952)</u>
Cost of sales	<u>92,395,076</u>
Gross profit	<u>11,751,856</u>
Operating expenses	
General and administrative	9,085,339
Depreciation	819,100
Amortization	<u>16,444</u>
Total operating expenses	<u>9,920,883</u>
Income from operations	<u>1,830,973</u>
Other income (expense)	
Rental income (net of expense)	19,860
Interest income	28,973
Gain on sale of equipment	7,669
Income from limited liability entity	4,693
Interest expense	<u>(311,090)</u>
Total other income (expense)	<u>(249,895)</u>
Net income	<u>\$ 1,581,078</u>

POWER SERVICE STATIONS, INC.
 STATEMENT OF CASH FLOWS
 FOR THE YEAR ENDED DECEMBER 31, 2006

Increase (decrease) in cash

Cash flows from operating activities	
Net income	\$ 1,581,078
Adjustments to reconcile net income to net cash provided by operating activities:	
Undistributed earnings of investee	(4,693)
Depreciation and amortization	835,544
Gain on sale of equipment	(7,669)
Changes in assets and liabilities:	
Accounts receivable	(371,162)
Inventories	(26,581)
Prepaid expenses	(26,381)
Accounts receivable – related party	(15,760)
Accounts payable	787,407
Accrued taxes and expenses	<u>(235,570)</u>
Net cash provided by operating activities	<u>2,516,213</u>
Cash flows from investing activities	
Purchase of property, plant and equipment	(637,518)
Proceeds from sale of property, plant and equipment	<u>12,825</u>
Net cash used by investing activities	<u>(624,693)</u>
Cash flows from financing activities	
Long-term borrowings	750,000
Repayments on long-term debt	(877,440)
Cash dividend distribution	<u>(600,451)</u>
Net cash used by financing activities	<u>(727,891)</u>
Net increase in cash	1,163,629
Cash at beginning of year	<u>1,061,842</u>
Cash at end of year	<u>\$ 2,225,471</u>

The accompanying notes are an integral part of these financial statements.

POWER SERVICE STATIONS, INC.
 NOTES TO FINANCIAL STATEMENTS
 DECEMBER 31, 2006

Following are selected financial statement disclosures that help illustrate the difference between consolidated and unconsolidated financial statements. They are not intended to be comprehensive notes to financial statements.

Note W – Long Term Debt

Long-term debt includes mortgage notes to Friendly Bank and a note payable to JR Investments, Ltd. Mortgage notes to Friendly Bank are collateralized by property, plant and equipment; the note payable to JR Investments, Ltd. is uncollateralized. Principal balances at December 31, 2006, are as follows.

Mortgage notes payable to bank, due in varying installments through 20XX, plus interest at X.X%	\$4,936,076
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Note payable to JR Investments, Ltd., due in quarterly installments of \$7,840 plus interest at X.X%	125,230
	<u>\$5,061,306</u>

Principal payments on long-term debt are due as follows:

2007	X,XXX,XXX
2008	X,XXX,XXX
2009	X,XXX,XXX
2010	X,XXX,XXX
Thereafter	<u>X,XXX,XXX</u>
Total	<u>\$5,061,306</u>

Note X - Commitments And Contingencies

In 19XX, the Company guaranteed mortgage loans made to JR Investments, Ltd. in connection with the acquisition by JR Investments, Ltd. of property, plant and equipment. The Company is the general partner of JR Investments, Ltd., whose sole business activity is letting the acquired property to the Company under operating leases. The amount of the guarantee was \$4,000,000; the unpaid balance of the loans is currently \$1,535,764.

Note Y - Related Party Transactions

The Company hires five of its service station locations under operating leases from JR Investments, Ltd. The Company owns 1% of JR Investments, Ltd. and is the general partner of JR Investments, Ltd. In addition, the

shareholders of the Company own 99% of JR Investments, Ltd. The Company made improvements costing \$56,087 during the year to a service station owned by JR Investments, Ltd., for which the Company is to be reimbursed by JR Investments, Ltd. The Company also has an outstanding note payable to JR Investments, Ltd. (see Note W).

Transactions and account balances with JR Investments, Ltd. consisted of the following:

Rent expense	<u>\$704,000</u>
Accounts receivable	<u>\$56,087</u>
Unsecured note payable	<u>\$125,230</u>
Interest expense	<u>\$5,789</u>

In addition, the Company is owed \$27,802 by John Smith, president and 50% owner of the Company for expense account advances.

Note Z – Equity Method

The Company uses the equity method of accounting for investments in and earnings or losses of affiliates that it does not control but over which it exerts a significant influence. The Company is the general partner of JR Investments, Ltd., in which it owns a 1% interest. Accordingly, the Company accounts for this investment by the equity method. The Company's recorded investment in JR Investments, Ltd. exceeds its underlying equity in the net assets of JR Investments, Ltd. by \$23,268. This amount is being amortized using the straight-line method over the life of related property, plant and equipment.

POWER SERVICE STATIONS, INC.
CONSOLIDATED BALANCE SHEET
DECEMBER 31, 2006

Assets	
Current assets	
Cash	\$ 2,404,188
Accounts receivable	2,333,853
Inventories	1,584,952
Prepaid expenses	<u>247,085</u>
Total current assets	6,570,078
Property, plant and equipment (at depreciated cost)	<u>11,442,513</u>
Other assets	
Accounts receivable – related party	27,802
Unamortized loan costs	<u>32,770</u>
Total other assets	<u>60,572</u>
Total assets	<u>\$ 18,073,163</u>
Liabilities and stockholders equity	
Current liabilities	
Accounts payable	\$ 2,805,483
Accrued taxes	582,745
Accrued expenses	379,292
Current maturities of long-term debt	<u>1,404,226</u>
Total current liabilities	5,171,746
Long-term liabilities	
Noncurrent maturities of long-term debt	<u>5,067,614</u>
Total liabilities	<u>10,239,360</u>
Stockholders equity	
Capital stock	25
Additional paid-in capital	60,767
Retained earnings	6,268,341
Noncontrolling interest	<u>1,504,670</u>
Total stockholders equity	<u>7,833,803</u>
Total liabilities and stockholders equity	<u>\$18,073,163</u>

The accompanying notes are an integral part of these financial statements.

POWER SERVICE STATIONS, INC.
CONSOLIDATED STATEMENT OF INCOME
FOR THE YEAR ENDED DECEMBER 31, 2006

Sales	<u>\$104,146,932</u>
Cost of sales	
Beginning inventories	1,558,371
Purchases	<u>92,421,657</u>
	93,980,028
Ending inventories	<u>(1,584,952)</u>
Cost of sales	<u>92,395,076</u>
Gross profit	<u>11,751,856</u>
Operating expenses	
General and administrative	8,382,863
Depreciation	964,173
Amortization	<u>19,056</u>
Total operating expenses	<u>9,366,092</u>
Income from operations	<u>2,385,764</u>
Other income (expense)	
Rental income (net of expense)	19,860
Interest income	28,260
Gain on sale of equipment	7,669
Other income	25,000
Interest expense	<u>(421,837)</u>
Total other income(expense)	<u>(340,048)</u>
Income before allocation to noncontrolling interest	2,045,716
Income attributable to noncontrolling interest	<u>(464,638)</u>
Net income	<u>\$ 1,581,078</u>

The accompanying notes are an integral part of these financial statements.

POWER SERVICE STATIONS, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 2006

Increase (decrease) in cash

Cash flows from operating activities

Net income	\$ 1,581,078
Adjustments to reconcile net income to net cash provided by operating activities:	
Income attributable to noncontrolling interest	464,638
Depreciation and amortization	983,229
Gain on sale of equipment	(7,669)
Changes in assets and liabilities:	
Accounts receivable	(371,162)
Inventories	(26,581)
Prepaid expenses	(26,381)
Accounts receivable – related party	(15,760)
Accounts payable	787,407
Accrued taxes and expenses	<u>(235,570)</u>
Net cash provided by operating activities	<u>3,133,229</u>

Cash flows from investing activities

Purchase of property, plant and equipment	(637,518)
Proceeds from sale of property, plant and equipment	<u>12,825</u>
Net cash used by investing activities	<u>(624,693)</u>

Cash flows from financing activities

Long-term borrowings	750,000
Repayments on long-term debt	(1,177,440)
Cash dividend distribution	<u>(600,451)</u>
Net cash used by financing activities	<u>(1,027,891)</u>

Net increase in cash	1,480,645
Cash at beginning of year	<u>923,543</u>
Cash at end of year	<u>\$ 2,404,188</u>

The accompanying notes are an integral part of these financial statements.

POWER SERVICE STATIONS, INC.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 DECEMBER 31, 2006

Following are selected financial statement disclosures that help illustrate the difference between consolidated and unconsolidated financial statements. They are not intended to be comprehensive notes to financial statements.

Note W – Long Term Debt

Long-term debt consists of mortgage notes to Friendly Bank, which are collateralized by property, plant and equipment. Mortgage notes are due in varying installments through 20XX and bear interest at an average rate of X.X%.

Principal balance at December 31, 2006	<u>\$6,471,840</u>
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Principal payments on long-term debt are due as follows:

2007	X,XXX,XXX
2008	X,XXX,XXX
2009	X,XXX,XXX
2010	X,XXX,XXX
Thereafter	<u>X,XXX,XXX</u>
Total	<u>\$6,471,840</u>

Note X - Variable Interest Entities

Effective January 1, 2005, the Company adopted Financial Accounting Standards Board Interpretation (FIN) No. 46(R), *Consolidation of Variable Interest Entities*, which requires companies to consolidate “variable interest entities” (VIEs) if those companies are the “primary beneficiaries” of those VIEs. VIEs are entities that are not controllable through voting interests or in which the equity investors do not bear the residual economic risks.

The Company is the general partner of JR Investments, Ltd. and owns one percent of that entity. Under FIN 46(R), JR Investments, Ltd. is a VIE and the Company is the primary beneficiary of JR Investments, Ltd.

The Company hires five of its 21 service station locations from JR Investments, Ltd., providing 100% of JR Investments, Ltd.’s rental income, and has guaranteed the long-term debt of JR Investments, Ltd.

This investment had previously been accounted for using the equity method. As a result of adopting FIN 46(R), the Company has consolidated, in its financial statements as of December 31, 2006, the assets, liabilities and

noncontrolling interest in JR Investments, Ltd. The effect of this consolidation was to increase assets \$2,915,204 and increase liabilities \$1,410,534.

Note Y - Related Party Transactions

The Company is owed \$27,802 by John Smith, president and 50% owner of the Company for expense account advances.