**Inter-company Transactions**

**Inter-company Inventory transactions**
- Transfers create no change in financial position
  - Recorded effects are eliminated by worksheet
- Downstream: Parent → Subsidiary
- Upstream: Parent ← Subsidiary
- Sale must be removed

JE entry TI: to remove sale

<table>
<thead>
<tr>
<th>Sales</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Goods Sold</td>
<td>xxx</td>
</tr>
</tbody>
</table>

- Unrealized Gains must be removed
  - Only realize gains when the inventory is sold to outside concerns or consumed
- When selling at a profit (inter-company), ending inventory is too high because CGS is understated, and profits are too high

JE entry G

<table>
<thead>
<tr>
<th>CGS</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>xxx</td>
</tr>
</tbody>
</table>

Only for transferred merchandise retained in business at the year end

JE entry *G (Same as G, but gain was created by transaction in previous year)

<table>
<thead>
<tr>
<th>Retained Earnings</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Goods Sold</td>
<td>xxx</td>
</tr>
</tbody>
</table>

- Consolidation entries are never posted to affiliate’s books
  - Year 1 – gain on inventory intercompany sale remained on separate books and was closed to retained earnings
  - Year 2 – buyer’s inventory and sellers RE contain unrealized profit
    - Profit is to be recognized when earning process is complete
- If original transfer is downstream (parent → sub), and equity method has been applied, replace RE with Equity in Subsidiary’s Earnings
- Non-Controlling Interest
  - Downstream → unrealized gain is that of parent
  - Upstream → gross profit recognized in subsidiary’s records
    - Allocate proportionate amount of intercompany profit adjustments from upstream sales to non-controlling interest
Consolidated Totals

- Revenues: Parent + Sub – intercompany transfer
- CGS = Parent + Sub – intercompany transfer = subtotal – any beginning unrealized gain (raises Net Income) and + any ending unrealized gain
- Expenses = Parent + Sub + amortization expense for year recognized on price allocations
- Non-controlling interest in Sub income = adjusted for effects of unrealized gains on upstream transfers x % of outside ownership
- RE @ beginning:
  - Other than equity method: Beginning RE must be converted to equity method (based on income actually earned by sub in previous years)
- Inventory = Parent + Sub – unrealized gain remaining @ end of current year (lower inventory to historical cost)
- Land, Buildings and Equipment = Parent + Sub +/- allocations +/- amortizations
- Non-controlling interest in sub @ end of year
  - Beginning interest (Book value at beginning – any unrealized gains on upstream sales) + portion of sub’s income – share of dividend payments
- Upstream: deferred profit adjusts sub’s earnings
- Downstream: deferred profit affects equity in sub

Inter-company land transfers

- Sale of land: cost basis when sold is the inter-company purchase price
  - Not historical cost
    - Historical cost must be reported as long as land remains in business combo.
  - Acquiring company capitalizes inflated price (DR)
- Gain reported by original seller (CR)
  - Unrealized gain of seller \(\rightarrow\) Retained Earnings
  - Gain deferred @ time of original transaction \(\rightarrow\) recognized + gain realized by inter-company seller
  - Land account of buyer overstated; RE of seller is overstated
  - Only when land is sold to outside parties \(\rightarrow\) recognized gain
    - Difference with inventory
      - No sales or CGS accounts
      - Sale of land to outsiders may occur after several years

**JE- TL**

<table>
<thead>
<tr>
<th>Gain on Sale of Land</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>xxx</td>
</tr>
</tbody>
</table>

Every subsequent consolidation, elimination process must be repeated

**JE- GL**

<table>
<thead>
<tr>
<th>Retained Earnings</th>
<th>xxx</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>xxx</td>
</tr>
</tbody>
</table>

- Non-controlling interest- land transfer
  - Downstream – no effect on non-controlling (profits relate to parent)
  - Upstream – deferral and recognition \(\rightarrow\) earnings affected for non-controlling interest

Consequences of land transfer

- Unrealized gain is deferred: land account reduced to historical cost
  - Gain in upstream sale is the amount excluded
- Each following year the unrealized gain is removed from beginning RE
  - Upstream: equity accrual based on sub’s adjusted RE
    - Non-controlling interest affected, but only in year of transfer and sale
Inter-company transfer of depreciable assets

- Deferral of unrealized gains
  - Defer gains
  - Maintain historical cost
- Property is disposed of by depreciation (not sale)
  - Systematic elimination of asset account (CR) and RE (DR)
  - Extra expense gradually offsets unrealized gain

JE Entry TA

<table>
<thead>
<tr>
<th>Description</th>
<th>XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on sale of equipment</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td></td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>XXX</td>
</tr>
</tbody>
</table>

To remove unrealized gain and return equipment to historical cost

JE Entry ED

<table>
<thead>
<tr>
<th>Description</th>
<th>XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accumulated Depreciation</td>
<td></td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td></td>
</tr>
</tbody>
</table>

Lower depreciation (purchase/ life \(\rightarrow\) historical cost/ life)

- Subsequent periods
  - Adjust individual company to consolidated totals
  - Update amounts because of depreciation’s impact

JE Entry TA

<table>
<thead>
<tr>
<th>Description</th>
<th>XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td></td>
</tr>
<tr>
<td>RE (Beginning – parent)</td>
<td>XXX</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td></td>
</tr>
</tbody>
</table>

Over life of asset- unrealized gain in RE will be systematically reduced to zero (due to excess depreciation on books)

- Equity method
  - When downstream, parent's RE has already been reduced for gain
    - Don’t adjust RE; investment in sub account adjusted instead

Intercompany Debt Transactions

- Effects recorded by individual companies \(\rightarrow\) isolated
- Re-cast in light of consolidation

Notes and loans

- Direct loans between affiliated companies are no problem
  - Reverse & eliminate receivable/payable with revenue/expenses
- Problem: Purchasing an affiliate’s debt from an outside party
  - Parent company acquires subsidiary bond on open mkt.
    - Liability is retired as of date of acquisition
  - No problem if price = book value of liability
- Problem
  - Debt originally sold under market conditions at a particular time
    - Premium or discount is amortized
  - Later acquisition influenced by current economic conditions and prevailing rates
  - Cost paid to purchase debt produces a difference in book value \(\rightarrow\) gain or loss
Accounting Problems
- Investment/debt accounts must be eliminated now and in future
- Revenue/Expense (with payable/receivable) is removed
- Changes are occurring constantly due to amortization
- Gain/loss on retirement must be recognized

JE (B):

<table>
<thead>
<tr>
<th>Description</th>
<th>XXX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds Payable (carrying value)</td>
<td></td>
</tr>
<tr>
<td>Interest Income</td>
<td></td>
</tr>
<tr>
<td>Loss on retirement</td>
<td></td>
</tr>
<tr>
<td>Investment in (parent) bonds</td>
<td></td>
</tr>
<tr>
<td>Interest expense</td>
<td></td>
</tr>
</tbody>
</table>

Question: Is loss or gain attributed to issuer or purchaser
- Only needed in calculating and reporting non-controlling interest

Four choices:
- Liability being extinguished is that of issuing company
  - Only debtor is affected by retirement
  - Acquiring company is serving as a purchasing agent
  - Economic unit concept
- Loss assigned to investor- income effect ➔ bond acquisition
- Gain or loss is split in some manner
- All repurchases are ultimately orchestrated by parent
  - Gain or loss ➔ parent

Intercompany Debt – subsequent to year of acquisition
- Amortization changes book value
- Losses and gains get smaller
  - Amortization gradually brings totals in RE account into agreement with consolidated balance
  - Already recognize gain or loss