I. INTERCOMPANY TRANSACTIONS

A. **What are intercompany transactions?** With respect to consolidated enterprises, intercompany transactions refer to any transactions between related parties of the consolidated group.

B. **What accounting issues are raised when intercompany transactions are present?**

1. Lack of Independence: Because the parties of the consolidated group are related, the transactions between members of the group are not at "arms length" i.e. they are not transactions between independent parties. Due to the lack of independence between the parties the effects of the transaction must be eliminated.

a. Example:

To illustrate, consider your family is a "consolidated group". You purchase a painting for $100 from a store (an independent party) and sell it to your "parent" for $150. You personally have made a $50 profit, but viewing the transaction from the perspective of the family (i.e. the consolidated entity), all that has occurred is that possession of the painting and $150 cash has changed hands. The assets (cash and painting) of the group have changed hands but the ownership interest of the consolidated group has not changed.

However, if your family (i.e. the "consolidated group) maintained accounting records, you would have recorded a profit of $50 and your parent would have recorded a painting at $150. Both of these entries are distortions because there is no realistic profit, simply an exchange of cash and an overvaluation of the painting on the books of the parent. Consequently to accurately reflect the "real" profit and assets of the consolidated group the misstated profit and asset must be corrected. This is accomplished by making what are known as "elimination" entries. These entries eliminate the effects of transactions that are not made "at arms' length".

There is a final consideration as well. While the parent may control more than 50% of your economic interests, let's say you have a "significant other" that is not a member of the consolidated group but also contributes to your economic well being and consequently has an economic interest in all financial matters that affect you. This is in effect a Minority Interest.

--A **minority interest**

- is a party that has an equity interest in you (owns some of your voting capital stock in a business sense). If your significant other considers themselves related only to you and not a member of the family group, he or she is in the same position as minority interest stockholders in a business sense.
- Because the MI is independent from the other members of the consolidated group, they are entitled to a share of the $50 profit based on the equity interest in all profits and losses generated by you and the fact that the spouse has no connection with the parent (independent party).
- This means that even though all traces of the transaction must be eliminated from the consolidated financial statements, the MI is still entitled to its equity interest in profits and losses. NOTE: You should recognize that the ability to allocate pro rata losses to MI shareholder on transactions dictated by the parent (not independent) raises some interesting possibilities from a business standpoint and problems for MI stockholders from an investment standpoint.
- Only "upstream" transactions affect the minority interest.

C. **Terminology:**

1. minority interest: stockholders owning less than a controlling interest; may or may not be related to the consolidated group in other investments but are always treated as non related in preparing consolidated financials
2. Downstream transactions: transactions that originate with "P"; i.e. sales from "P" to "S"; "S" buys "P" bonds;
   a. no MI implications
3. upstream transactions: transactions that originate with "S"; i.e. sales from "S" to "P"; "P" buys "S" bonds;
   a. significant MI implications; MI must be allocated pro rata shares of gains and losses on upstream transactions
4. lateral transactions: transactions between related subsidiaries; i.e. sales from "S_1" to "S_2"; "S_2" buys "S_3" bonds; these transactions are handled in the same manner as upstream transactions
   a. significant MI implications; MI must be allocated pro rata shares of gains and losses on upstream transactions

D. **Types of intercompany transactions:**

1. Sales of inventory (goods held for sale in the ordinary course of business; goods in or soon to be in production)

RULE: --all gross profit on sales of inventory must be eliminated until realized through sales to outsiders;
--the sale and CGS must be eliminated

ELIMINATIONS:	DOWNSTREAM		UPSTREAM	
Profit in ending inventory:	CGS (amount of profit).......	xxx	CGS (amount of profit).......	xxx
	Inventory................	xxx	Inventory................	xxx
Profit in beginning inventory:	"P"-RE (amount of profit)..	.xxx	"P"-RE (P%)(amount of Profit)	xxx
	CGS......................	xxx	"S"-RE (S%)(amount of profit)	xxx
			CGS......................	xxx
Sale itself:	Sales (amount of the sale)...	xxx	Sales (amount of the sale)...	xxx
	CGS...........................	xxx	CGS...........................	xxx

E. **SPECIAL CONSIDERATIONS IN SALES OF INVENTORY**

1. Profits: always eliminate the gross profit on any intercompany sale
2. Transportation costs:

FOB shipping point (buyer incurs costs): no special treatment because the costs are added to the cost of inventory; inventory is part of COS so these costs are already considered part of gross π.

FOB destination (seller incurs costs): deduct the amount of the shipping costs from the elimination of gross profit; these costs are part of selling and administrative expense for the seller and as such are deducted from income by seller in the current period even if inventory is still being held; to fail to reduce the profit by the amount of these charges would result in them being charged against income twice.

3. Inventories carried at lower of cost or market:

RULE: eliminate the profit remaining on the consolidated books after the markdown to LCM
Example: -- "P" purchases goods in open market for $50,000 and sells to "S" for $65,000.
-- "S" uses LCM rule for inventory and marks goods down to $56,000.

Solution: The amount of intercompany profit still on the books is the difference between the arms length cost to the consolidated entity and the goods current carrying value ($56,000 - $50,000) or $6,000. Therefore the elimination of intercompany profit in ending inventory for this downstream sale is:

CGS (amount of profit).......	6,000	
Inventory................		6,000

F. **Losses on intercompany transactions:**

RULE:non-depreciable assets: loss can only be recognized to the extent that sales price is greater than FMV;

depreciable assets:loss can be recognized immediately to the extent that sales price is greater than FMV; to the extent that SP is less than FMV the loss must be deferred and recognized ratably over the remaining life of the asset (similar treatment to gains on depreciable assets)

Example:--"P" sells "S" a machine for $15,000. The machine cost "P" $30,000 and had accumulated depreciation of $6,000 at the time of the sale.

--At the date of the sale the FMV of the machine was determined to be $20,000.

--At the date of the sale the machine has 5 years remaining life.

Solution: The easiest procedure is twofold:

1. eliminate the entire loss
2. make a separate entry to recognize the loss allowable to date.

(Although this is more cumbersome than making one compound entry, it has advantages in being easy to remember, apply and audit in future periods.)

Cost to "P".........	$30,000	
Less: A/D................	6,000	
BV..................	$24,000	
Sales Price:	15,000	
Apparent loss.......		$ 9,000
FMV................	$20,000	
SP.................	15,000	
Deferred loss.......		$ 5,000
Recognized loss.....		$ 4,000

Record sale of Machine:

Seller books:			Buyer books:	
Cash.........	15		Machine.........	15
A/D..........	6		Cash.........	15
Loss.........	9			
Machine...		30		

Consolidated Adjustment/eliminations: 12/31/x1 (first year)

1. defer the entire loss:

A/D.......... 5 --note how this offsets the loss booked by seller
Loss....... 5

2. recognize the loss allowable to date

Deprec. Exp.. 1 --the dr to deprec. exp. reduces NI; recognizes loss
A/D........ 1

Consolidated Adjustment/eliminations: 12/31/x2 (second year)

1. defer the entire loss:

A/D.......... 5 --note how this offsets the loss booked by seller
"P"-RE..... 5

2. recognize the loss allowable to date

Deprec. Exp...1 --the dr to deprec. exp. reduces NI; recognizes loss
"P"-RE........ 1 --reinstate the adj.entry made last year on work papers
"S"-RE........ --used to allocate share to MI if this were "upstream"
A/D........ 2 --recognizes total deferred loss recognized to date

Consolidated Adjustment/eliminations: 12/31/x3 (third year)

(To illustrate the year 3 entry and also the effects of an upstream sale to a partially owned subsidiary, give the entry to recognize the loss allowable to date in year 3 assuming the sale were upstream to a 90% parent:

1. defer the entire loss:

A/D.......... 5 --note how this offsets the loss booked by seller
"P"-RE..... 5

2. recognize the loss allowable to date

Deprec. Exp...1 --the dr to deprec. exp. reduces NI; recognizes loss
"P"-RE........ 1.8 --reinstate the adj.entry made last year on work papers
"S"-RE........ 0.2 --used to allocate share to MI if this were "upstream"
A/D........ 2 --recognizes total deferred loss recognized to date

G. **Sales of non-depreciable assets:**

RULE: all gain must be deferred until the asset is sold to outsiders

Year 1:			Subsequent years:			
Gain...........	xxx		"P"-RE..........	xxx		
Asset........		xxx	"S"-RE..........	xxx		← used if transaction in upstream
			Asset........		xxx	

H. **Sales of depreciable assets:**

RULE:

1. eliminate the entire gain at the time of the sale;
2. recognize gain ratably over the life of the asset

Example:

--Asset cost...................$ 45,000
A/D............................. 15,000
BV.............................. 30,000
SP.............................. 42,000
Gain............................ 12,000
Remaining life: 3 years
For upstream example assume "P" owns 80% of "S" voting C/S

Solution: Sales of Depreciable Assets

ELIMINATION: (EOY1)	DOWNSTREAM			UPSTREAM		
Eliminate gain at	Gain........................	12,000		Gain........................	12,000	
date of sale or EOY1:	Asset....................		12,000	Asset...................		12,000
Gain recognized EOY1:	A/D (gain recog to date).....	4,000		A/D.........................	4,000	
	Depreciation expense......		4,000	Depreciation expense....		4,000
Eliminate gain EOY2	RE "P"......................	12,000		RE-"P" (12,000)(.8)..........	9,600	
	Asset....................		12,000	RE-"S".(12,000)(.2)..........	2,400	
				Asset....................		12,000
Gain recognized EOY2:	A/D (gain recog to date).....	8,000		A/D.........................	8,000	
	RE-"P" (past)............		4,000	RE-"P" (4,000)(.8)........		3,200
	Depr expense (current yr)		4,000	RE-"S" (4,000)(.2)........		800
				Depreciations Expense....		4,000

NOTE:

1. No entries would be needed at EOY3; the asset would be fully depreciated on the consolidated books so all the gain booked by the seller at the point of sale can be recognized (i.e. we don't need to defer it any more through adjustment and elimination entries)

2. Although these entries are less elegant than a single compound entry, they possess a symmetry and logic that make them intuitively easier to remember after an extended absence or during the stress of an audit or exam. Remember, they only appear in the working papers, they are not booked and they will be used by others to check the validity of the figures you come up with.

I. **Intercompany long-term construction contracts:**

The issue: Construction of an asset for an affiliate is the presents the same issues as constructing as asset for self-use as studied in intermediate accounting (specifically:

a. allocation of overhead during the construction process and
b. capitalization of interest costs during the construction process.

1. Allocation of Overhead: overhead is capitalized or expensed depending upon the idle capacity available;

a. --no idle capacity: overhead is allocated on the same basis as normal production or construction
--idle capacity: to the extent that overhead is directly traceable to the self-construction project and the cost of getting the information is not material, only incremental overhead should be allocated.
--In no case can full cost exceed FMV

2. Capitalization of Interest Costs incurred during and after the construction period

General Rule: SFAS-34 requires capitalization of interest costs for assets that:

a. are not yet being used in earning activities and;
b. are undergoing preparation for future use.

specific requirements:

a. assets constructed by the enterprise for self-use;
b. assets constructed by outsiders if progress payments or deposits are made;
c. land under development for a particular use;
d. assets intended for sale or lease that are constructed as discrete projects.

AMOUNT OF INTEREST TO CAPITALIZE:

a. use the interest rate on specific borrowings if available;
b. if no borrowings are directly traceable to the construction, use the weighted average interest rate on all borrowings during the construction period only;

Consolidated Elimination Entries: Intercompany Transactions

In a consolidated setting: (Different procedures are required during and after the construction of the asset)

a. during construction: the effects of the issues discussed above (overhead and interest) on income must be accounted for.

1. Procedure--Completed contract method:

Billings (contra acct to CIP)........	xxxxx		This entry leaves only the costs incurred
A/P-LT construction project........	yyyyy		to date by the constructing affiliate on
Asset under construction....		xxxxx	the cons. BS; (includes OH and interest);
A/R-LT construction project....		yyyyy	

2. Procedure--% completion method:

Billings (contra acct to CIP).	xxxxx		
A/P-LT construction project	xxxxx		
Asset under construction........		xxxxx	
A/R-LT construction project...		xxxxx	
"P"-RE (profit recog in past)......	xxxxx		The CIP account contains profit recognized
Earned income on const (present)...		xxxxx	to date; the intercompany profit must be
CIP (total profit recog to date)....		xxxxx	eliminated

b. after construction: once the project is completed and sold to the affiliate, the normal procedures for the sale of a depreciable asset are followed (i.e. all intercompany profits and receivables must be eliminated).

J. **Intercompany discounting of notes**

RULE:--Note is made be a member of the affiliated group: all traces of the note must be eliminated
--Note is made by an outsider but discounted to an affiliate:
1. the note itself is a valid asset and must be reflected in the consolidated financials;
2. all aspects of discounting the note must be eliminated

N/R discounted......................	xxxxx	
N/R............................		xxxxx
Unearned interest revenue.........	xxxxx	
Interest revenue (current year).	xxxxx	
Interest expense................		xxxxx

K. **Miscellaneous:** all intercompany Revenues/Expenses; Receivables/payables must be eliminated