Intercompany Profit Transactions – Plant Assets

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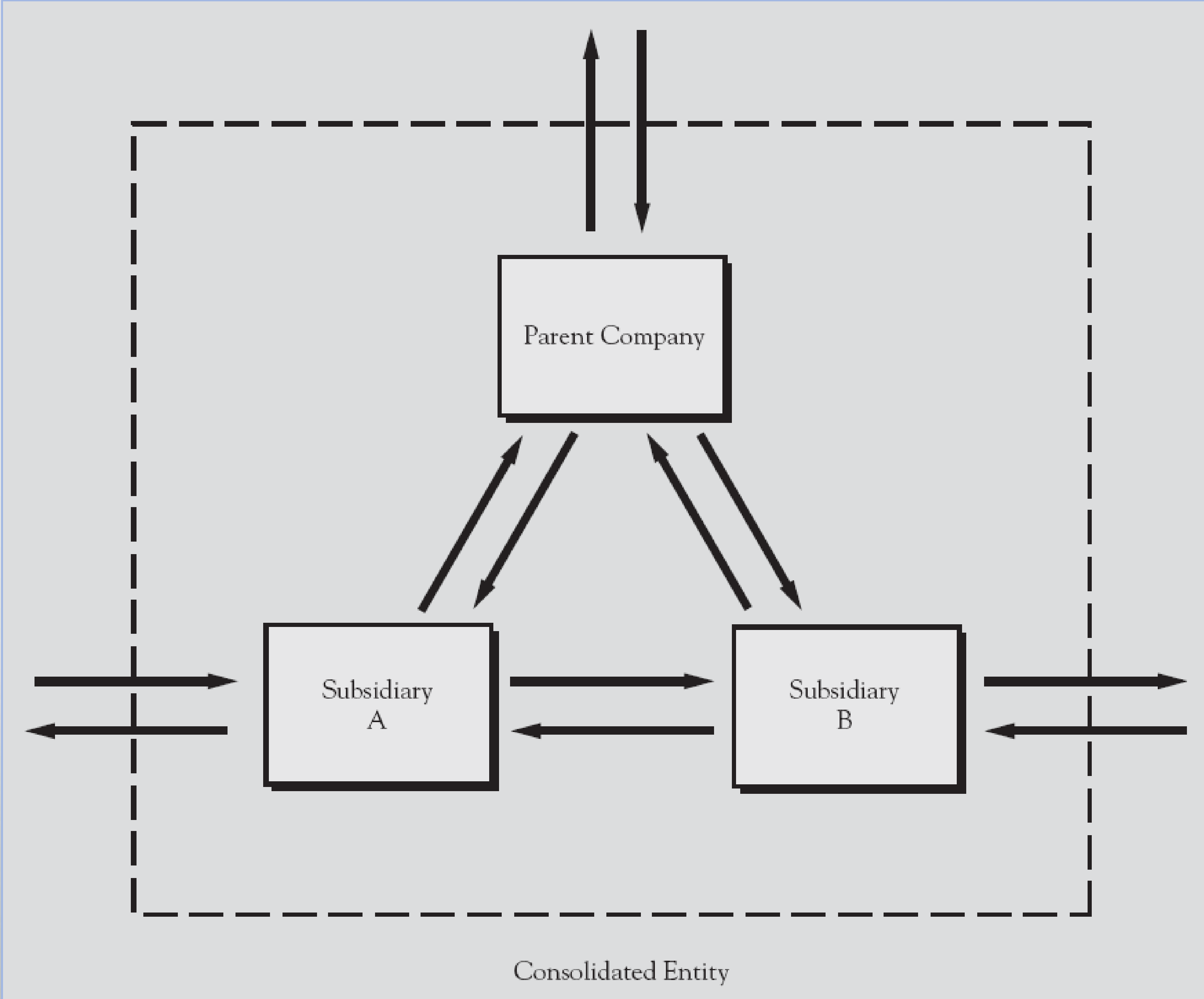
OVERVIEW OF THE CONSOLIDATED ENTITY

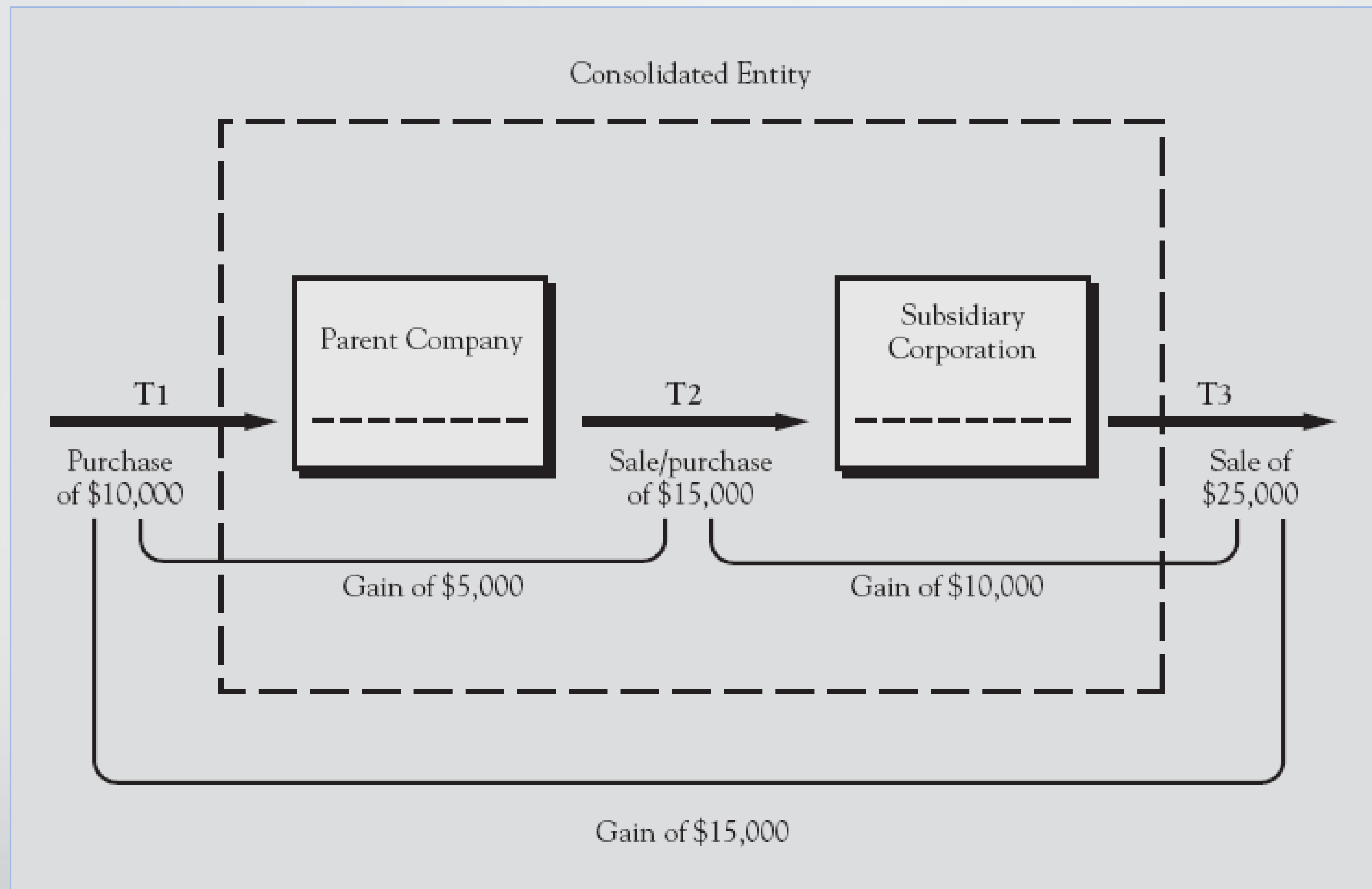
Elimination of intercompany transfers

- All aspects of intercompany transfers must be eliminated in preparing consolidated financial statements so that the statements appear as if they were those of a single company
- No distinction is made between wholly owned and less-than-wholly owned subsidiaries
- Focus is on the single-entity concept


Parent Company
Subsidiary
A
Subsidiary
B
Consolidated Entity

Elimination of unrealized profits and losses

- Profit or loss from selling an item to a related party normally is considered realized at the time of the sale from the selling company’s perspective
- The profit is not considered realized for consolidation purposes until confirmed, usually through resale to an unrelated party
- Unrealized intercompany profit is the unconfirmed profit from an intercompany transfer



T1—Purchase by Parent Company from outsider for $10,000.

T2—Sale from Parent Company to Subsidiary Corporation for $15,000.

T3—Sale from Subsidiary Corporation to outsider for $25,000.

Intercompany Sale Process - Illustration

- Case A
  - All three transactions are completed in the same accounting period. The gain amounts reported are:

Parent Company	$ 5,000 ($15,000 - $10,000)
Subsidiary Corporation	10,000 ($25,000 - $15,000)
Consolidated Entity	15,000 ($25,000 - $10,000)

- Case B
  - Only transaction T1 is completed during the current period. The gain amounts reported are:

Parent Company	$ -0-
Subsidiary Corporation	-0-
Consolidated Entity	-0-

Intercompany Sale Process - Illustration

- Case C
  - Only transactions T1 and T2 are completed during the current period. The gain amounts reported are:

Parent Company	$ $5,000 ($15,000 - $10,000)
Subsidiary Corporation	-0-
Consolidated Entity	-0-

- Case D
  - Only transaction T3 is completed during the current period, T1 and T2 having occurred in a prior period. The gain amounts reported are:

Parent Company	$ -0-
Subsidiary Corporation	10,000 ($25,000 - $15,000)
Consolidated Entity	15,000 ($25,000 - $10,000)

INTERCOMPANY TRANSFERS OF SERVICES

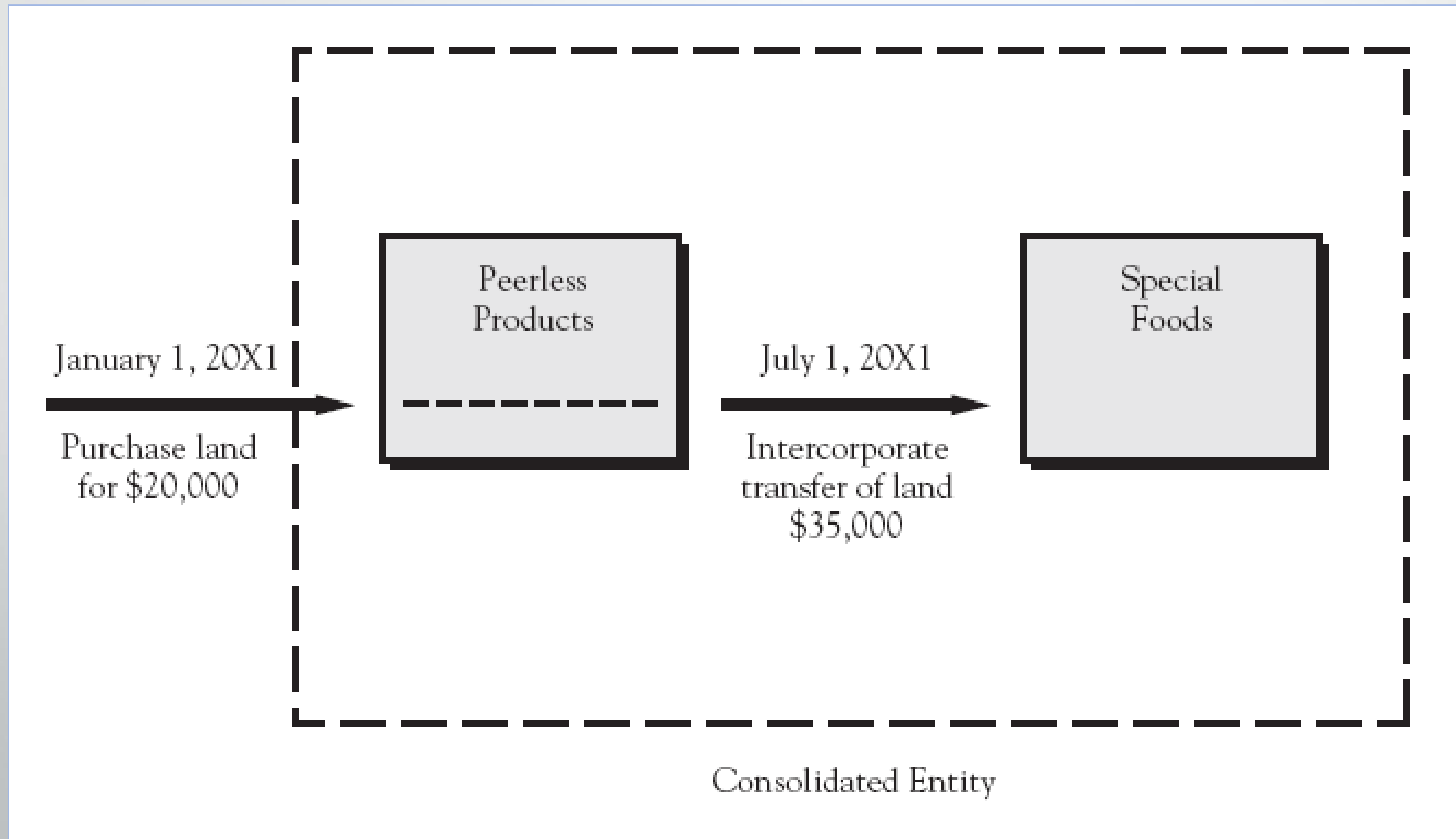
- When one company purchases services from a related company, the purchaser typically records an expense and the seller records a revenue
  - In the consolidation workpaper, an eliminating entry would be needed to reduce both revenue (debit) and expense (credit)
  - Because the revenue and expense are equal and both are eliminated, income is unaffected by the elimination
  - The elimination is still important because otherwise both revenues and expenses are overstated

INTERCOMPANY TRANSFERS OF LAND

Overview of the profit elimination process

- No special adjustments or eliminations are needed when land is transferred between related companies at book value
- Land transfers at more or less than book value
  - Selling entity's gain/ loss must be eliminated because the land is still held by the consolidated entity
  - The land must be reported at its original cost in the consolidated financial statements as long as it is held within the consolidated entity, regardless of which affiliate holds the land

Peerless Products Corporation acquires land for $20,000 on January 1, 20X1, and sells the land to its subsidiary, Special Foods Incorporated, on July 1, 20X1, for $35,000, as follows:



Intercompany Transfers of Land - Illustration

- Peerless records the purchase of the land and its sale:

	Debit	Credit
January 1, 20X1		
Land	**20,000**	
Cash		**20,000**
Record purchase of land.		
July 1, 20X1		
Cash	**35,000**	
Land		**20,000**
Gain on Sale of Land		**15,000**
Record sale of land to Special Foods.		

- Special Foods records the purchase:

	Debit	Credit
July 1, 20X1		
Land	**35,000**	
Cash		**35,000**
Record purchase of land from Peerless.		

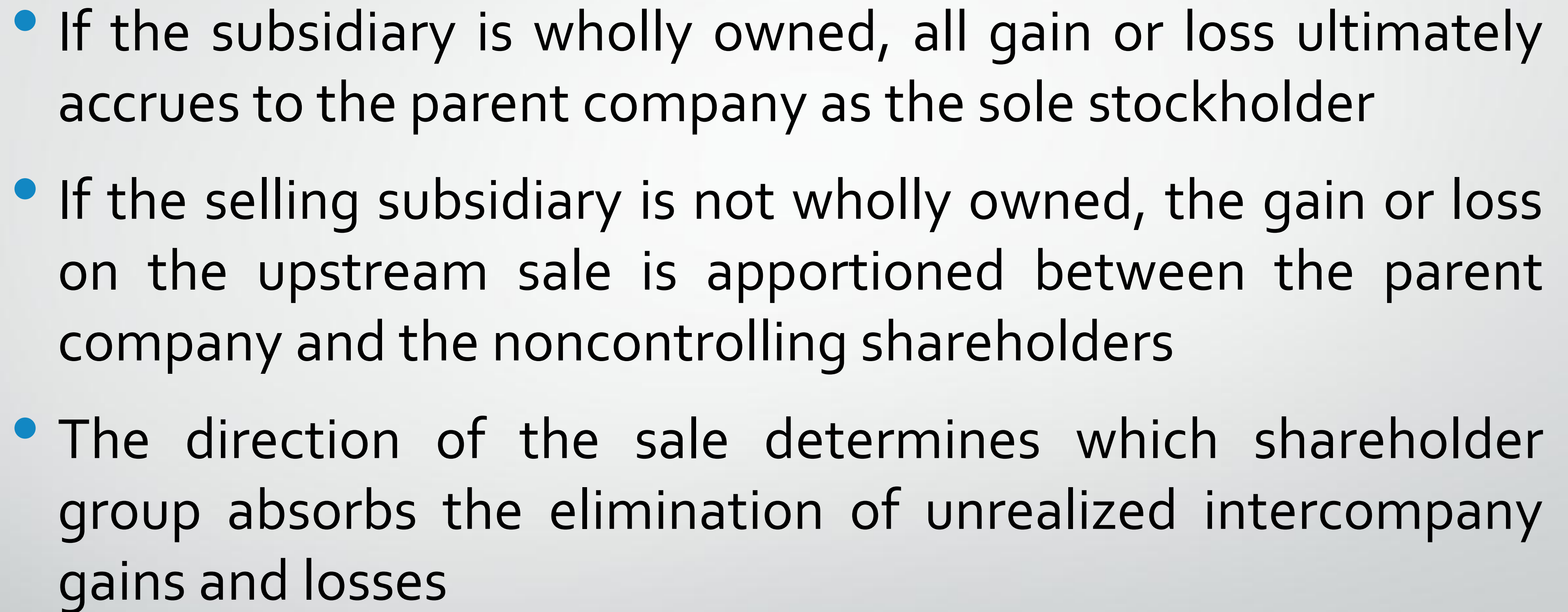
- The transfer causes the seller to recognize a $15,000 gain and the carrying value of the land to increase by the same amount
  - The gain must be eliminated in the preparation of consolidated statements and the land restated from the $35,000 recorded on Special Foods' books to its original cost of $20,000
  - Eliminating entry in the consolidation workpaper prepared at the end of 20X1:

		Debit	Credit
E(4)	**Gain on Sale of Land**	**15,000**	
	Land		**15,000**
	Eliminate unrealized gain on sale of land.		

INTERCOMPANY TRANSFERS OF LAND

Assignment of unrealized profit elimination

- Regardless of the parent's percentage ownership of a subsidiary, the full amount of any unrealized gains and losses must be eliminated and must be excluded from consolidated net income
- When a sale is from a parent to a subsidiary, referred to as a **downstream sale**, any gain or loss on the transfer accrues to the parent company's stockholders
- When the sale is from a subsidiary to its parent, an **upstream sale**, any gain or loss accrues to the subsidiary's stockholders



- If the subsidiary is wholly owned, all gain or loss ultimately accrues to the parent company as the sole stockholder
- If the selling subsidiary is not wholly owned, the gain or loss on the upstream sale is apportioned between the parent company and the noncontrolling shareholders
- The direction of the sale determines which shareholder group absorbs the elimination of unrealized intercompany gains and losses

Sale	Elimination
Downstream (parent to subsidiary)	Against controlling interest
Upstream (subsidiary to parent):	
Wholly owned subsidiary	Against controlling interest
Majority-owned subsidiary	Proportionately against controlling and noncontrolling interests

- Unrealized intercompany gains and losses are eliminated in consolidation in the following ways:

Downstream Sale - Illustration

1. Peerless Products acquires 80 percent of Special Foods Inc.'s stock on December 31, 20X0, at the stock's book value of $240,000. The fair value of Special Foods' noncontrolling interest on that date is $60,000, the book value of those shares.

2. On July 1, 20X1, Peerless sells land to Special Foods for $35,000. It had originally purchased the land on January 1, 20X1, for $20,000. Special Foods continues to hold the land through 20X1 and subsequent years.

3. During 20X1, Peerless reports separate income of $155,000, consisting of income from regular operations of $140,000 and a $15,000 gain on the sale of land; Peerless declares dividends of $60,000. Special Foods reports net income of $50,000 and declares dividends of $30,000.

4. Peerless accounts for its investment in Special using the basic equity method, under which it records its share of Special Foods' net income and dividends but does not adjust for unrealized intercompany profits.

- Basic equity-method entries—20X1

		Debit	Credit
(5)	**Cash**	**24,000**	
	Investment in Special Foods Stock		**24,000**
	Record dividends from Special Foods		
(6)	**Investment in Special Foods Stock**	**40,000**	
	Income from Subsidiary		**40,000**
	Record equity-method income		

- On December 31, 20X1, the investment account on Peerless's books appears as follows:

Investment in Special Foods Stock					
	Original cost	240,000			
(6)	Equity accrual ($50,000 × .80)	40,000	(5)	Dividends ($30,000 × .80)	24,000
	Balance, 12/31/X1	256,000			

Eliminating Entries:			
E(7)	**Income from Subsidiary**	**40,000**	
	Dividends Declared		**24,000**
	Investment in Special Foods Stock		**16,000**
	Eliminate income from subsidiary.		
E(8)	**Income to Noncontrolling Interest**	**10,000**	
	Dividends Declared		**6,000**
	Noncontrolling Interest		**4,000**
	Assign income to noncontrolling interest. $10,000 = $50,000 x .20 $6,000 = $30,000 x .20		
E(9)	**Common Stock—Special Foods**	**200,000**	
	Retained Earnings, January 1	**100,000**	
	Investment in Special Foods Stock		**240,000**
	Noncontrolling Interest		**60,000**
	Eliminate beginning investment balance.		
E(10)	**Gain on sale of Land**	**15,000**	
	Land		**15,000**
	Eliminate unrealized gain on downstream sale of land.		

- The consolidation workpaper used in preparing consolidated financial statements for 20X1 is shown in Figure 6–3 in the text.

- Consolidated net income for 20X1

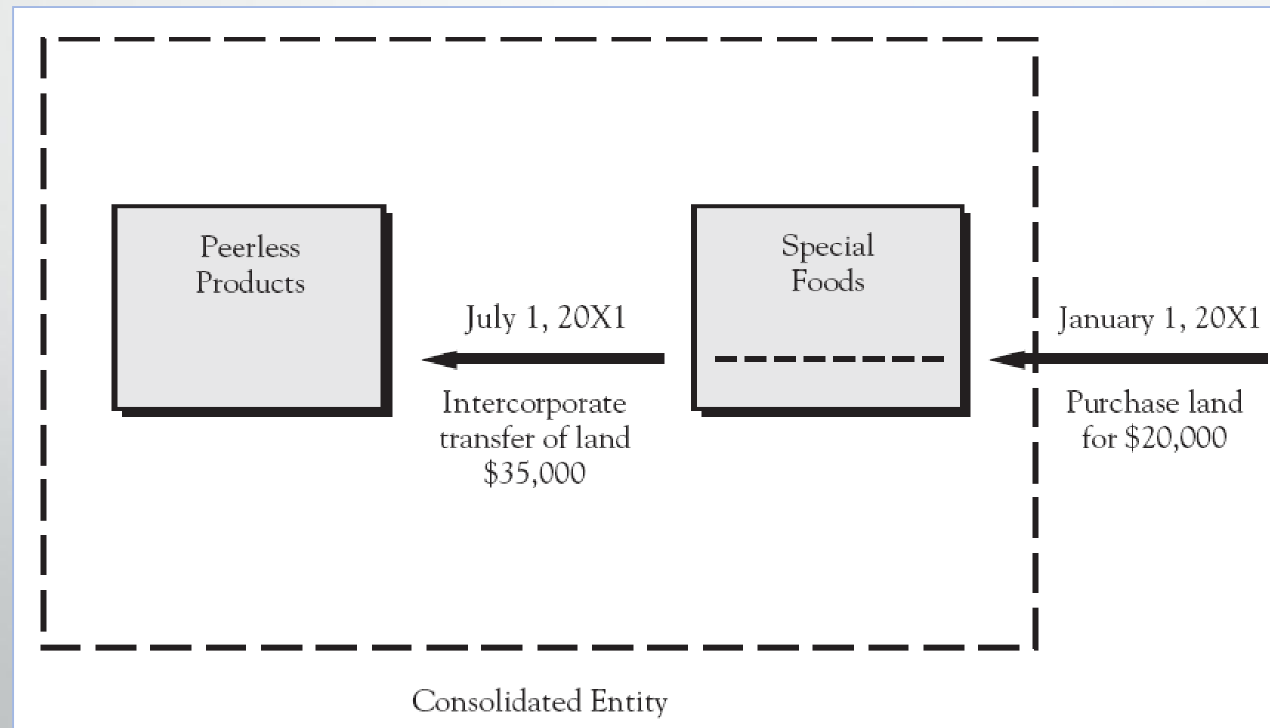
Peerless's separate income	$155,000
Less: Unrealized intercompany gain on downstream land sale	(15,000)
Peerless's separate realized income	$140,000
Special Foods' net income	50,000
Consolidated net income, 20X1	$190,000
Income to noncontrolling interest ($50,000 × .20)	(10,000)
Income to controlling interest	$180,000

- Noncontrolling interest

Book value of Special Foods, December 31, 20X1:	
Common stock	$200,000
Retained earnings	120,000
Total book value	$320,000
Noncontrolling stockholders' proportionate share	× .20
Noncontrolling interest, December 31, 20X1	$ 64,000

Upstream Sale - Illustration

Use the same example used to illustrate a downstream sale. In this case, Special Foods recognizes a $15,000 gain from selling the land to Peerless in addition to the $50,000 of income earned from its regular operations; thus, Special Foods' net income for 20X1 is $65,000. Peerless's separate income is $140,000 and comes entirely from its normal operations.



- Basic equity-method entries—20X1

(11)	**Cash**	**24,000**	
	Investment in Special Foods Stock		**24,000**
	Record dividends from Special Foods		
(12)	**Investment in Special Foods Stock**	**52,000**	
	Income from Subsidiary		**52,000**
	Record equity-method income		

- The investment account on Peerless's books at the end of 20X1:

Investment in Special Foods Stock					
	Original cost	240,000			
(12)	Equity accrual		(11)	Dividends	
	($65,000 × .80)	52,000		($30,000 × .80)	24,000
	Balance, 12/31/X1	268,000			

Eliminating Entries:

		Debit	Credit
E(13)	**Income from Subsidiary**	**52,000**	
	Dividends Declared		**24,000**
	Investment in Special Foods Stock		**28,000**
	Eliminate income from subsidiary.		
E(14)	**Income to Noncontrolling Interest**	**10,000**	
	Dividends Declared		**6,000**
	Noncontrolling Interest		**4,000**
	Assign income to noncontrolling interest: \$10,000 = (\$65,000 - \$15,000) x .20 \$6,000 = \$30,000 x .20		
E(15)	**Common Stock—Special Foods**	**200,000**	
	Retained Earnings, January 1	**100,000**	
	Investment in Special Foods Stock		**240,000**
	Noncontrolling Interest		**60,000**
	Eliminate beginning investment balance.		
E(16)	**Gain on Sale of Land**	**15,000**	
	Land		**15,000**
	Eliminate unrealized gain on upstream sale of land.		

- The consolidation workpaper prepared at the end of 20X1 appears in Figure 6–4 in the text.

The only procedural difference in the upstream and downstream elimination process:

- Unrealized intercompany profits of the subsidiary from upstream sales are eliminated proportionately against the controlling and noncontrolling interests
- Unrealized intercompany profits of the parent from downstream sales are eliminated totally against the controlling interest.

- Consolidated net income for 20X1

Peerless's separate income		$140,000
Special Foods' net income	$65,000	
Less: Unrealized intercompany gain on upstream land sale	(15,000)	
Special Foods' realized net income		50,000
Consolidated net income, 20X1		$190,000
Income to noncontrolling interest ($50,000 × .20)		(10,000)
Income to controlling interest		$180,000

- Noncontrolling interest

Special Foods' net income	$65,000
Less: Unrealized intercompany profit on upstream land sale	(15,000)
Special Foods' realized income	$50,000
Proportionate share to noncontrolling interest	× .20
Income to noncontrolling interest	$10,000

- Noncontrolling interest

Book value of Special Foods, December 31, 20X1:	
Common stock	$200,000
Retained earnings	135,000
Total book value	$335,000
Unrealized intercompany gain on upstream land sale	(15,000)
Realized book value of Special Foods	$320,000
Noncontrolling stockholders' proportionate share	× .20
Noncontrolling interest, December 31, 20X1	$ 64,000

INTERCOMPANY TRANSFERS OF LAND

- Eliminating unrealized profits after the first year
  - In a downstream sale, the following eliminating entry is needed in the consolidation workpaper each year after the year of the downstream sale of the land, for as long as the subsidiary holds the land:

		Debit	Credit
E(17)	**Retained Earnings, January 1**	**15,000**	
	Land		**15,000**
	Eliminate unrealized gain on prior-period downstream sale of land.		

- In the upstream case, in the consolidation workpaper prepared in years subsequent to the intercompany transfer while the land is held by the parent, the unrealized intercompany gain is eliminated from the reported balance of the land and proportionately from the subsidiary ownership interests with the following entry:

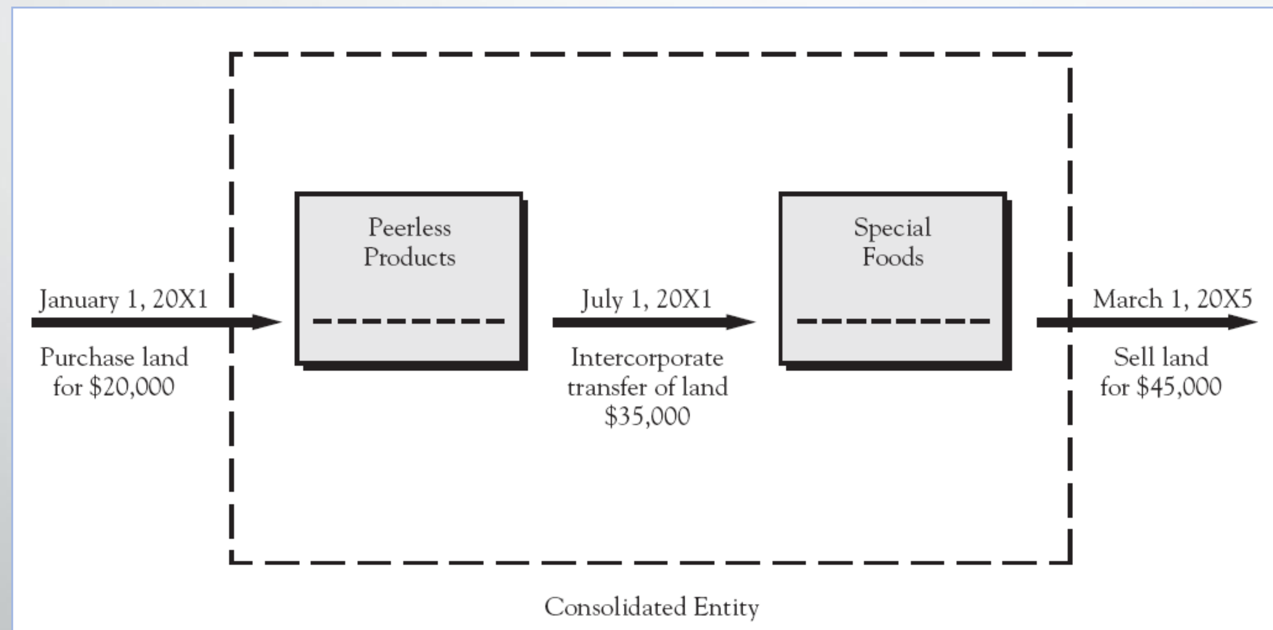
E(18)	**Retained Earnings, January 1**	**12,000**	
	Noncontrolling Interest	**3,000**	
	Land		**15,000**
	Eliminate unrealized gain on prior-period upstream sale of land.		

SUBSEQUENT DISPOSITION OF ASSET

- Unrealized profits on intercompany sales of assets are viewed as being realized at the time the assets are resold to external parties
  - The gain or loss recognized by the affiliate selling to the external party must be adjusted for consolidated reporting by the amount of the previously unrealized intercompany gain or loss
  - While the seller's reported profit on the external sale is based on that affiliate's cost, the gain or loss reported by the consolidated entity is based on the cost of the asset to the consolidated entity
  - The effects of the profit elimination process must be reversed

Subsequent Disposition of Asset - Illustration

Assume that Peerless purchases land from an outside party for $20,000 on January 1, 20X1, and sells the land to Special Foods on July 1, 20X1, for $35,000. Special Foods subsequently sells the land to an outside party on March 1, 20X5, for $45,000, as follows:



- Special Foods recognizes a gain on the sale to the outside party of $10,000
  - From a consolidated viewpoint, the gain is $25,000 ($45,000 - $20,000)
  - Eliminating entry made in the consolidation workpaper prepared at the end of 20X5:

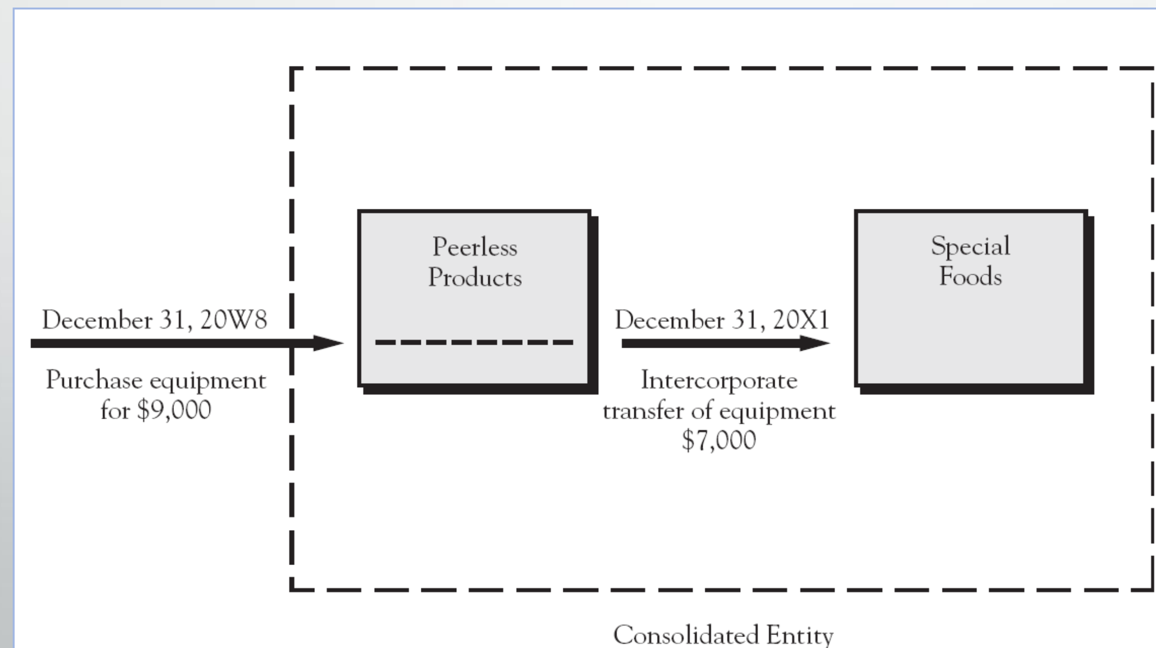
E(19)	**Retained Earnings, January 1**	**15,000**	
	Gain on Sale of Land		**15,000**
	Adjust for previously unrealized intercompany gain on sale of land.		

INTERCOMPANY TRANSFERS OF DEPRECIABLE ASSETS

- Unrealized intercompany profits on a depreciable or amortizable asset are viewed as being realized gradually over the remaining economic life of the asset as it is used by the purchasing affiliate in generating revenue from unaffiliated parties.
  - From a consolidated viewpoint, depreciation must be based on the cost of the asset to the consolidated entity

Downstream Sale - Illustration

Peerless sells equipment to Special Foods on December 31, 20X1, for $7,000. The equipment originally cost Peerless $9,000 when purchased three years before, and is being depreciated over a total life of 10 years using straight-line depreciation with no residual value. The book value of the equipment immediately before the sale is $6,300. The gain recognized by Peerless on the intercompany sale is $700 ($7,000 - $6,300).



- Separate-company entries—20X1
  - Special Foods

December 31, 20X1		
Equipment	**7,000**	
Cash		**7,000**
Record purchase of equipment.		

  - Peerless:

December 31, 20X1	**900**	
Depreciation Expense		**900**
Accumulated Depreciation		
Record 20X1 depreciation expense on equipment sold.		

December 31, 20X1		
Cash	**7,000**	
Accumulated Depreciation	**2,700**	
Equipment		**9,000**
Gain on Sale of Equipment		**700**
Record sale of equipment.		

- Peerless also records the normal basic equity-method entries to recognize its share of Special Foods' income and dividends

Eliminating Entries:			
E(25)	**Income from Subsidiary**	**40,000**	
	Dividends Declared		**24,000**
	Investment in Special Foods Stock		**16,000**
	Eliminate income from subsidiary.		
E(26)	**Income to Noncontrolling Interest**	**10,000**	
	Dividends Declared		**6,000**
	Noncontrolling Interest		**4,000**
	Assign income to noncontrolling interest: $10,000 = $50,000 x .20		
E(27)	**Common Stock—Special Foods**	**200,000**	
	Retained Earnings, January 1	**100,000**	
	Investment in Special Foods Stock		**240,000**
	Noncontrolling Interest		**60,000**
	Eliminate beginning investment balance.		
E(28)	**Buildings and Equipment**	**2,000**	
	Gain on Sale of Equipment	**700**	
	Accumulated Depreciation		**2,700**
	Eliminate unrealized gain on downstream sale of equipment.		

The workpaper to prepare consolidated financial statements at the end of 20X1 appears in Figure 6–5 in the text.

During 20X2, Special Foods begins depreciating the $7,000 cost of the equipment acquired from Peerless Products over its remaining life of seven years using straight-line depreciation. The resulting depreciation is $1,000 per year ($7,000 / 7 years):

- Separate-Company Entries—20X2

Depreciation Expense	**1,000**	
Accumulated Depreciation		**1,000**
Record depreciation expense for 20X2.		

Peerless records its normal equity-method entries for 20X2 to reflect its share of Special Foods’ $74,000 income and dividends of $40,000:

- The investment account on Peerless's books appears as follows:

Investment in Special Foods Stock					
	Original cost	240,000			
(24)	20X1 equity accrual ($50,000 × .80)	40,000	(23)	20X1 dividends ($30,000 × .80)	24,000
	Balance, 12/31/X1	256,000			
(31)	20X2 equity accrual ($74,000 × .80)	59,200	(30)	20X2 dividends ($40,000 × .80)	32,000
	Balance, 12/31/X2	283,200			

The consolidation workpaper for 20X2 is presented in Figure 6–6 in the text.

Eliminating Entries:

Entry	Account	Debit	Credit
E(32)	**Income from Subsidiary**	**59,200**	
	Dividends Declared		**32,000**
	Investment in Special Foods Stock		**27,200**
	Eliminate income from subsidiary.		
E(33)	**Income to Noncontrolling Interest**	**14,800**	
	Dividends Declared		**8,000**
	Noncontrolling Interest		**6,800**
	Assign income to noncontrolling interest:		
E(34)	**Common Stock—Special Foods**	**200,000**	
	Retained Earnings, January 1	**120,000**	
	Investment in Special Foods Stock		**256,000**
	Noncontrolling Interest		**64,000**
	Eliminate beginning investment balance.		
E(35)	**Buildings and Equipment**	**2,000**	
	Retained Earnings, January 1	**700**	
	Accumulated Depreciation		**2,700**
	Eliminate unrealized gain on equipment.		
E(36)	**Accumulated Depreciation**	**100**	
	Depreciation Expense		**100**
	Eliminate excess depreciation.		

Once all the eliminating entries have been made in the workpaper, the adjusted balances exclude the effects of the intercorporate transfer:

	Subsidiary Trial Balance	Elimination	Consolidated Amounts
Buildings and Equipment	$7,000	$2,000	$9,000
Accumulated Depreciation	(1,000)	(2,600)	(3,600)
Depreciation Expense	1,000	(100)	900

- Consolidated net Income

Peerless's separate income	$160,900
Partial realization of intercompany gain on downstream sale of equipment	100
Peerless's separate realized income	$161,000
Special Foods' net income	74,000
Consolidated net income, 20X2	$235,000
Income to noncontrolling interest ($74,000 × .20)	(14,800)
Income to controlling interest	$220,200

Downstream Sale - Illustration

- Consolidated retained earnings

Peerless's retained earnings, December 31, 20X2		$580,800
Less: Unrealized 20X1 intercompany gain	$700	
20X2 partial realization of gain	(100)	(600)
Consolidated retained earnings, December 31, 20X2		$580,200

- Noncontrolling interest

Book value of Special Foods, December 31, 20X2:	
Common stock	$200,000
Retained earnings	154,000
Total book value	$354,000
Noncontrolling stockholders' proportionate share	× .20
Noncontrolling interest, December 31, 20X2	$ 70,800

Downstream Sale

- The consolidation procedures in subsequent years are quite similar to those in 20X2
  - As long as Special Foods continues to hold and depreciate the equipment, consolidation procedures must include:
    1. Restating the asset and accumulated depreciation balances
    2. Adjusting depreciation expense for the year
    3. Reducing beginning retained earnings by the amount of the intercompany gain unrealized at the beginning of the year

Downstream Sale

- Change in estimated life of asset upon transfer
  - The treatment is no different than if the change occurred while the asset remained on the books of the transferring affiliate
  - The new remaining useful life is used as a basis for depreciation both by the purchasing affiliate and for purposes of preparing consolidated financial statements

Upstream Sale

- The treatment of unrealized profits arising from upstream intercompany sales is identical to that of downstream sales except that the unrealized profit, and subsequent realization, must be allocated between the controlling and noncontrolling interests

Upstream Sale

- Asset transfers before year-end
  - A portion of the intercompany gain or loss is considered realized in the period of the transfer
  - The year-end eliminating entries must include an adjustment of depreciation expense and accumulated depreciation
  - The adjustment is equal to the difference between the depreciation recorded by the purchaser and that which would have been recorded by the seller during the portion of the year elapsing after the intercorporate sale

Intercompany Transfers of Amortizable Assets

- Accounting for intangible assets usually differs from accounting for tangible assets in that amortizable intangibles normally are reported at the remaining unamortized balance without the use of a contra account
    - Other than netting the accumulated amortization on an intangible asset against the asset cost, the intercompany sale of intangibles is treated the same in consolidation as the intercompany sale of tangible assets

THANK YOU