Intercompany Profit Transactions – Bonds

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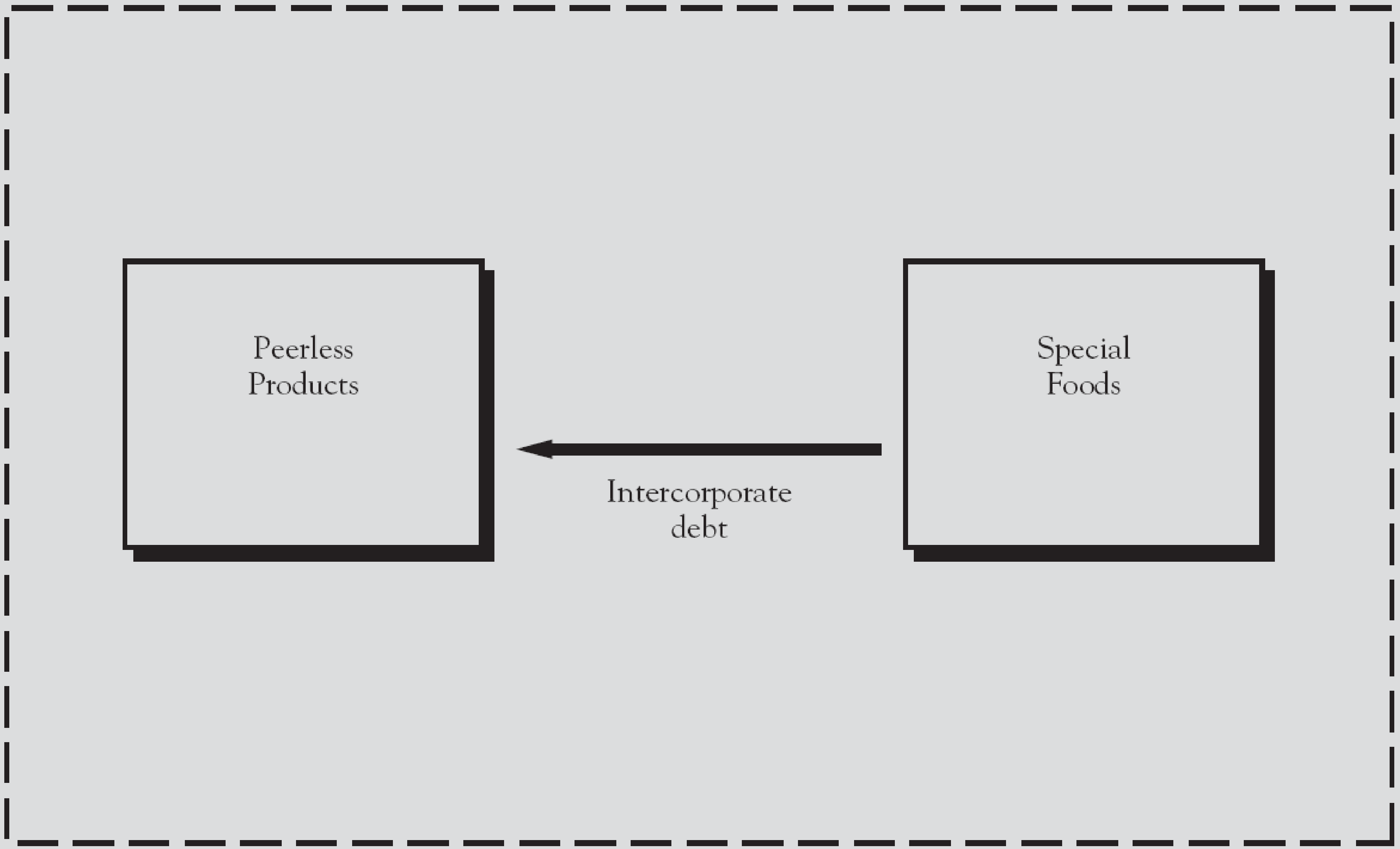
CONSOLIDATION OVERVIEW

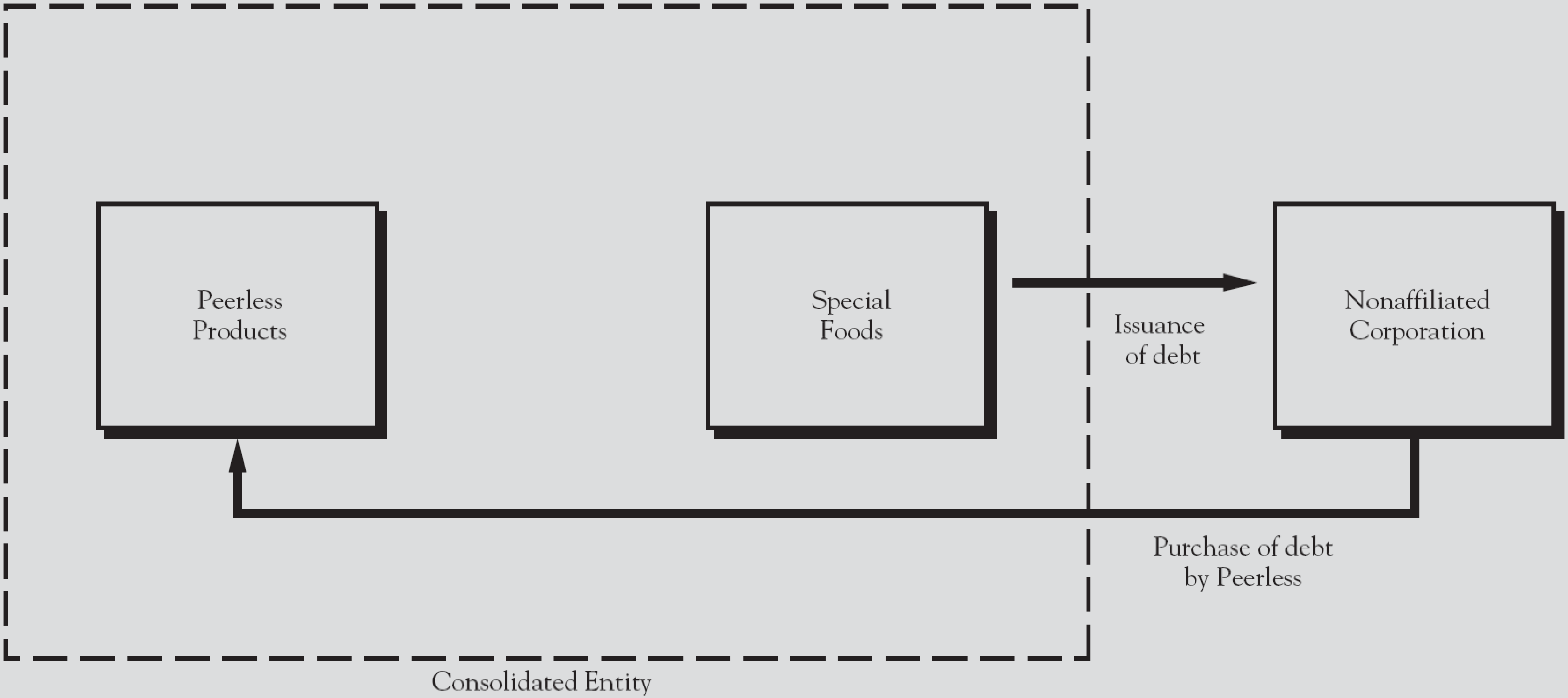
- A direct intercompany debt transfer involves a loan from one affiliate to another without the participation of an unrelated party
- An indirect intercompany debt transfer involves the issuance of debt to an unrelated party and the subsequent purchase of the debt instrument by an affiliate of the issuer

(*a*) Direct Intercompany Debt Transfer



Consolidated Entity

(*b*) Indirect Intercompany Debt Transfer



BOND SALE DIRECTLY TO AN AFFILIATE

- When one company sells bonds directly to an affiliate, all effects of the intercompany indebtedness must be eliminated in preparing consolidated financial statements
- Transfer at par value

Assume that on January 1, 20X1, Special Foods borrows $100,000 from Peerless Products by issuing $100,000 par value, 12 percent, 10-year bonds. During 20X1, Special Foods records interest expense on the bonds of $12,000 ($100,000 x .12), and Peerless records an equal amount of interest income.

In the preparation of consolidated financial statements for 20X1, two elimination entries are needed in the consolidation workpaper to remove the effects of the intercompany indebtedness:

Eliminating Entries:			
E(1)	**Bonds Payable**	**100,000**	
	Investment in Special Foods Bonds		**100,000**
	Eliminate intercorporate bond holdings.		
E(2)	**Interest Income**		
	Interest Expense	**12,000**	
	Eliminate intercompany interest.		**12,000**

These entries have no effect on consolidated net income because they reduce interest income and interest expense by the same amount.

- Transfer at a discount or premium
  - Bond interest income or expense recorded do not equal cash interest payments
  - Interest income/ expense amounts are adjusted for the amortization of the discount or premium

On January 1, 20X1, Peerless Products purchases $100,000 par value, 12 percent, 10-year bonds from Special Foods for $90,000. Interest on the bonds is payable on January 1 and July 1. The interest expense recognized by Special Foods and the interest income recognized by Peerless each year include straight-line amortization of the discount, as follows:

Cash interest ($100,000 x .12)	$12,000
Amortization of discount ($10,000 / 20 semiannual interest periods) x 2 periods	1,000
Interest expense or income	$13,000

- Entries by the debtor

January 1, 20X1		
Cash	**90,000**	
Discount on Bonds Payable	**10,000**	
Bonds Payable		**100,000**
Issue bonds to Peerless Products.		
July 1, 20X1		
Interest Expense	**6,500**	
Discount on Bonds Payable		**500**
Cash		**6,000**
Semiannual payment of interest.		
December 31, 20X1		
Interest Expense	**6,500**	
Discount on Bonds Payable		**500**
Interest Payable		**6,000**
Accrue interest expense at year-end.		

- Entries by the bond investor

January 1, 20X1		
Investment in Special Foods Bonds	**90,000**	
Cash		**90,000**
Purchase of bonds from Special Foods.		
July 1, 20X1		
Cash	**6,000**	
Investment in Special Foods Bonds	**500**	
Interest Income		**6,500**
Receive interest on bond investment.		
December 31, 20X1		
Interest Receivable	**6,000**	
Investment in Special Foods Bonds	**500**	
Interest Income		**6,500**
Accrue interest income at year-end.		

Elimination entries at year-end			
E(9)	**Bonds Payable**	**100,000**	
	Investment in Special Foods Bonds		**91,000**
	Discount on Bonds Payable		**9,000**
	Eliminate intercorporate bond holdings.		
E(10)	**Interest Income**	**13,000**	
	Interest Expense		**13,000**
	Eliminate intercompany interest.		
E(11)	**Interest Payable**	**6,000**	
	Interest Receivable		**6,000**
	Eliminate intercompany interest receivable/payable.		

Entry E(9) eliminates the bonds payable and associated discount against the investment in bonds.

Entry E(10) eliminates the bond interest income recognized by Peerless during 20X1 against the bond interest expense recognized by Special Foods.

Entry E(11) eliminates the interest receivable against the interest payable.

Consolidation at the end of 20X2 requires elimination entries similar to those at the end of 20X1.

Because $1,000 of the discount is amortized each year, the bond investment balance on Peerless's books increases to $92,000.

Elimination entries at year-end - 20X2			
E(9)	**Bonds Payable**	**100,000**	
	Investment in Special Foods Bonds		**92,000**
	Discount on Bonds Payable		**8,000**
	Eliminate intercorporate bond holdings.		
E(10)	**Interest Income**	**13,000**	
	Interest Expense		**13,000**
	Eliminate intercompany interest.		
E(11)	**Interest Payable**	**6,000**	
	Interest Receivable		**6,000**
	Eliminate intercompany interest receivable/payable.		

BONDS OF AFFILIATE PURCHASED FROM A NONAFFILIATE

- Scenario: Bonds that were issued to an unrelated party are acquired later by an affiliate of the issuer
  - From the viewpoint of the consolidated entity, an acquisition of an affiliate's bonds retires the bonds at the time they are purchased
- Acquisition of the bonds of an affiliate by another company within the consolidated entity is referred to as constructive retirement
  - Although the bonds actually are not retired, they are treated as if they were retired in preparing consolidated financial statements

When a constructive retirement occurs:

- The consolidated income statement for the period reports a gain or loss on debt retirement based on the difference between the carrying value of the bonds on the books of the debtor and the purchase price paid by the affiliate
- Neither the bonds payable nor the purchaser's investment in the bonds is reported in the consolidated balance sheet because the bonds are no longer considered outstanding

Purchase at book value

- Elimination entries are identical to those used in eliminating a direct intercorporate debt transfer
- The total of the bond liability and the related premium/discount reported by the debtor equal the balance in the investment account shown by the bondholder, and the interest income reported by the bondholder each period equals the interest expense reported by the debtor
- All of these amounts need to be eliminated

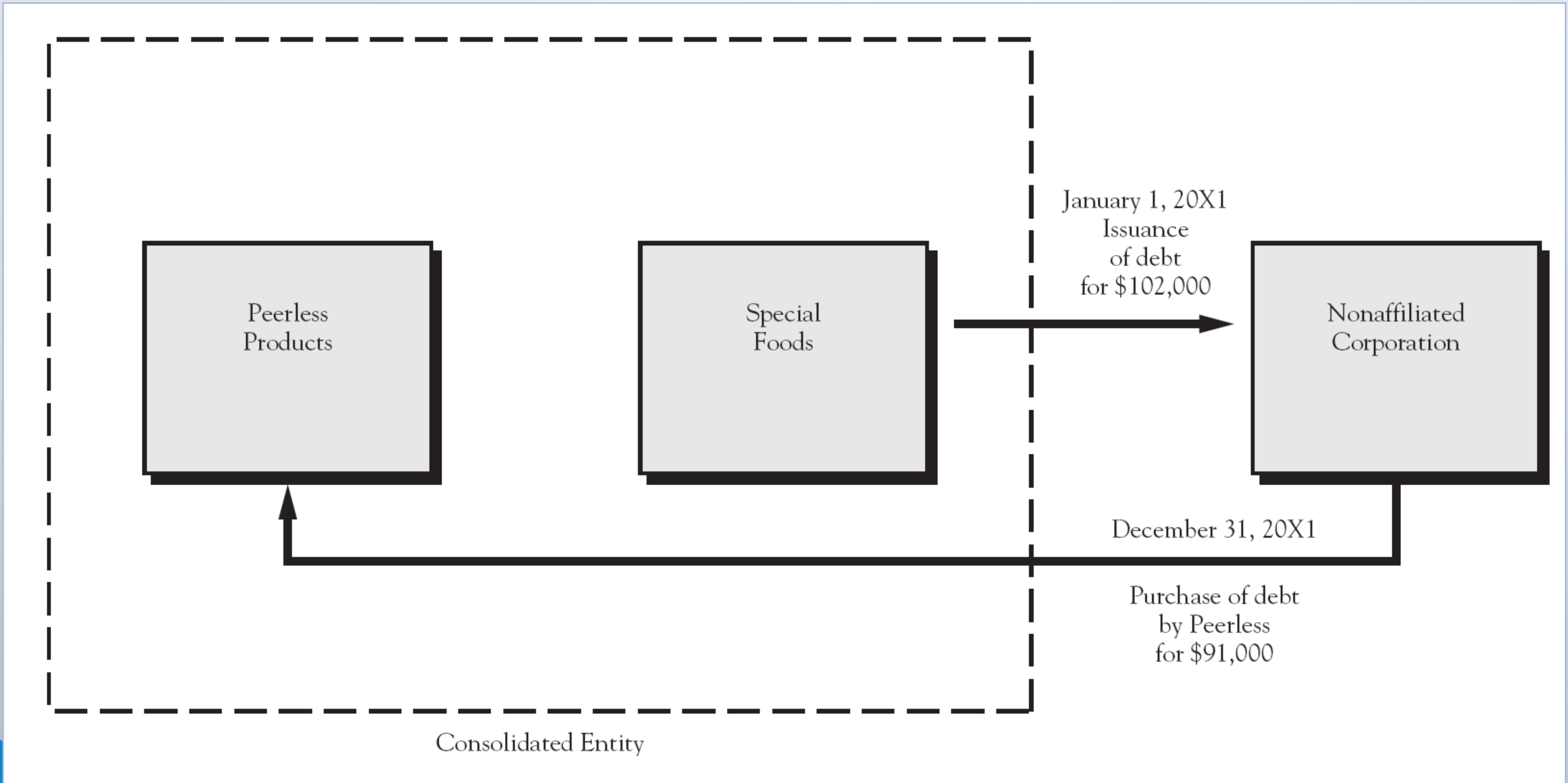
Purchase at an amount less than book value

- When the price paid to acquire the bonds of an affiliate differs from the liability reported by the debtor, a gain or loss is reported in the consolidated income statement in the period of constructive retirement
- The bond interest income and interest expense reported by the two affiliates subsequent to the purchase must be eliminated in preparing consolidated statements
- Interest income reported by the investing affiliate and interest expense reported by the debtor are not equal in this case because of the different bond carrying amounts on the books of the two companies

Peerless Products Corporation acquires 80 percent of the common stock of Special Foods Inc. on December 31, 20X0, for its underlying book value of $240,000. At that date, the fair value of the noncontrolling interest is equal to its book value of $60,000. Additionally:

1. On January 1, 20X1, Special Foods issues 10-year, 12 percent bonds payable with a par value of $100,000; the bonds are issued at 102. Nonaffiliated Corporation purchases the bonds from Special Foods.
2. The bonds pay interest on June 30 and December 31.
3. Both Peerless and Special amortize bond discount and premium using the straight-line method.
4. On December 31, 20X1, Peerless purchases the bonds from Nonaffiliated for $91,000.
5. Special Foods reports net income of $50,000 for 20X1 and $75,000 for 20X2 and declares dividends of $30,000 in 20X1 and $40,000 in 20X2.
6. Peerless earns $140,000 in 20X1 and $160,000 in 20X2 from its own separate operations. Peerless declares dividends of $60,000 in both 20X1]and 20X2.

Bonds of Affiliate Purchased from a Nonaffiliate - Illustration



Bonds of Affiliate Purchased from a Nonaffiliate - Illustration

Bond Liability Entries—20X1 (Special Foods)		
January 1, 20X1		
Cash	**102,000**	
Bonds Payable		**100,000**
Premium on Bonds Payable		**2,000**
Sale of bonds to Nonaffiliated.		
June 30, 20X1		
Interest Expense	**5,900**	
Premium on Bonds Payable	**100**	
Cash		**6,000**
Semiannual payment of interest:		
$5,900 = $6,000 - $100		
$100 = $2,000 / 20 interest periods		
$6,000 = $100,000 x .12 x 6/12		
December 31, 20X1		
Interest Expense	**5,900**	
Premium on Bonds Payable	**100**	
Cash		**6,000**
Semiannual payment of interest.		

Total interest expense for 20X1 is $11,800 ($5,900 x 2), and the book value of the bonds on December 31, 20X1, is as follows:

Book value of bonds at issuance	**$102,000**
Amortization of premium, 20X1	**(200)**
Book value of bonds, December 31, 20X1	**$101,800**

Bond Investment Entries—20X1 (Peerless)		
December 31, 20X1		
Investment in Special Foods Bonds	**91,000**	
Cash		**91,000**
Purchase of Special Foods bonds from Nonaffiliated Corporation.		

Computation of Gain on Constructive Retirement of Bonds	
Book value of Special Foods' bonds, December 31, 20X1	**$101,800**
Price paid by Peerless to purchase bonds	**(91,000)**
Gain on constructive retirement of bonds	**$10,800**

This gain is included in the consolidated income statement as a gain on the retirement of bonds.

Assignment of gain - constructive retirement

Four approaches have been used:

1. The affiliate issuing the bonds
2. The affiliate purchasing the bonds
3. The parent company
4. The issuing and purchasing companies, based on the difference between the carrying amounts of the bonds on their books at the date of purchase and the par value of the bonds

Peerless also records the normal basic equity-method entries during 20X1. The December 31, 20X1, workpaper to prepare consolidated financial statements for Peerless and Special Foods is presented in Figure 8–2 in the text. Eliminating entries:

E(21)	**Income from Subsidiary**	**40,000**	
	Dividends Declared		**24,000**
	Investment in Special Foods Stock		**16,000**
	Eliminate income from subsidiary.		
E(22)	**Income to Noncontrolling Interest**	**12,160**	
	Dividends Declared		**6,000**
	Noncontrolling Interest		**6,160**
	Assign income to noncontrolling interest:		
	$12,160 = ($50,000 + $10,800) x .20		
E(23)	**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(24)	**Bonds Payable**	**100,000**	
	Premium on Bonds Payable	**1,800**	
	Investment in Special Foods Bonds		**91,000**
	Gain on Bond Retirement		**10,800**
	Eliminate intercorporate bond holdings.		

- Consolidated Net Income—20X1

Peerless's separate income		$140,000
Special Foods' net income	$50,000	
Gain on constructive retirement of bonds	10,800	
Special Foods' realized net income		60,800
Consolidated net income, 20X1		$200,800
Income to noncontrolling interest ($60,800 × .20)		(12,160)
Income to controlling interest		$188,640

- Noncontrolling Interest—December 31, 20X1

Book value of Special Foods, December 31, 20X1:	
Common stock	$200,000
Retained earnings	120,000
Total reported book value	$320,000
Gain on constructive retirement of bonds	10,800
Realized book value of Special Foods	$330,800
Noncontrolling stockholders' share	× .20
Noncontrolling interest, December 31, 20X1	$ 66,160

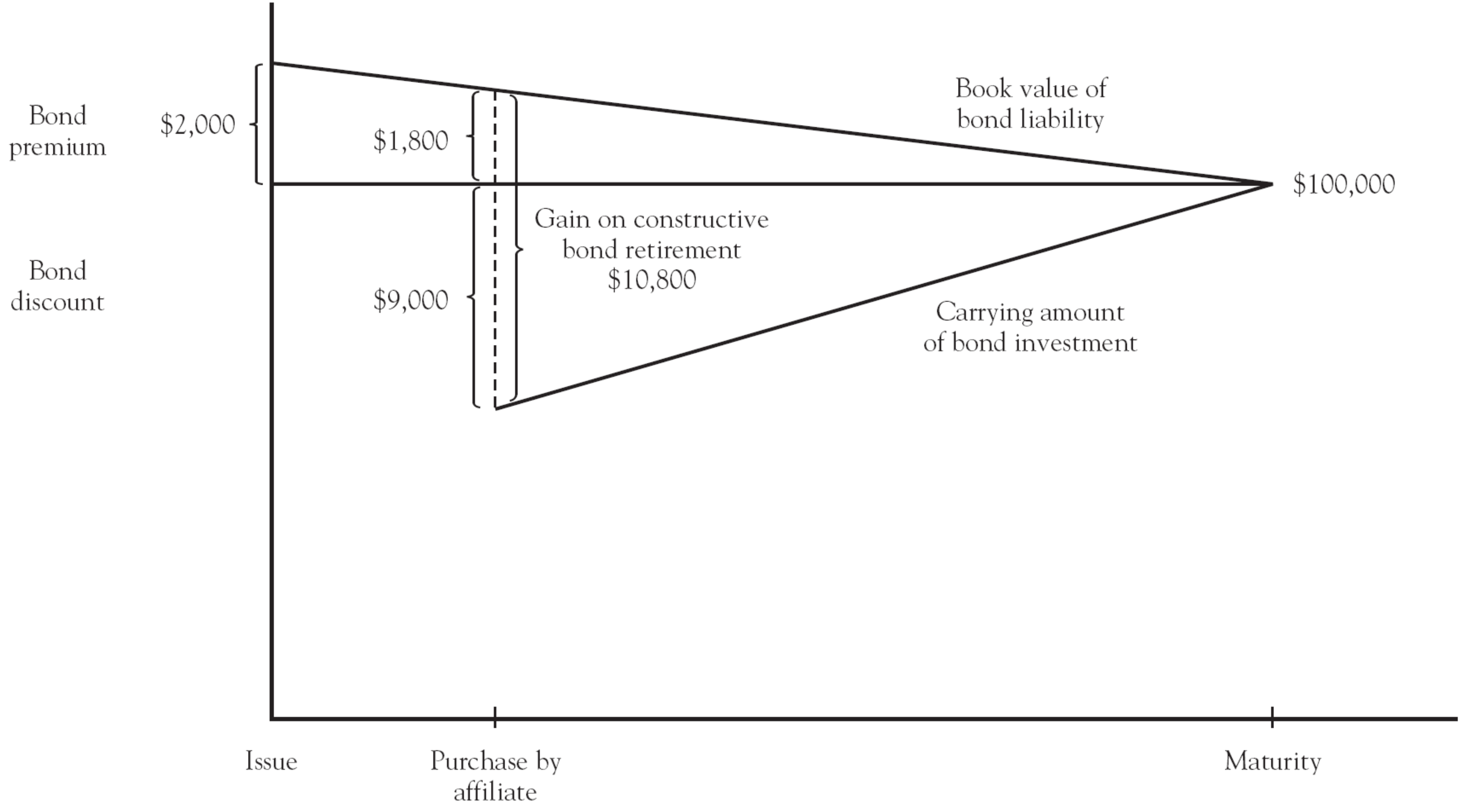
Bond Liability Entries—20X2 (Special Foods)		
June 30, 20X2		
Interest Expense	**5,900**	
Premium on Bonds Payable	**100**	
Cash		**6,000**
Semiannual payment of interest.		
December 31, 20X2		
Interest Expense	**5,900**	
Premium on Bonds Payable	**100**	
Cash		**6,000**
Semiannual payment of interest.		

Bond Investment Entries—20X2 (Peerless)		
June 30, 20X2		
Cash	**6,000**	
Investment in Special Foods Bonds	**500**	
Interest Income		**6,500**
Record receipt of bond interest.		
December 31, 20X2		
Cash	**6,000**	
Investment in Special Foods Bonds	**500**	
Interest Income		**6,500**
Record receipt of bond interest.		

Subsequent recognition of gain on constructive retirement

In 20X1, the entire $10,800 gain on the retirement was recognized in the consolidated income statement but not on the books of either Peerless or Special Foods

Peerless's discount on bond investment	**$9,000**
Special Foods' premium on bond liability	**1,800**
Total gain on constructive retirement of bonds	**$10,800**


Bond
premium
$2,000
$1,800
Book value of
bond liability
$100,000
Gain on constructive
bond retirement
$10,800
Bond
discount
$9,000
Carrying amount
of bond investment
Issue
Purchase by
affiliate
Maturity

In each year subsequent to 20X1, both Peerless and Special Foods recognize a portion of the constructive gain as they amortize the discount on the bond investment and the premium on the bond liability:

Peerless's amortization of discount on bond investment ($9,000 ÷ 9 years)	$1,000
Special Foods' amortization of premium on bonds payable ($1,800 ÷ 9 years)	200
Annual increase in combined incomes of separate companies	$1,200

Basic Equity-Method Entries—20X2

	Debit	Credit
Cash		
Investment in Special Foods Stock	**32,000**	
Record dividends from Special Foods:		**32,000**
$40,000 x .80		
Investment in Special Foods Stock	**60,000**	
Income from Subsidiary		**60,000**
Record equity-method income:		
$75,000 x .80		

Investment in Special Foods Stock

	Original cost	240,000			
(20)	20X1 equity accrual		(19)	20X1 dividends	
	($50,000 × .80)	40,000		($30,000 × .80)	24,000
	Balance, 12/31/X1	256,000			
(30)	20X2 equity accrual		(29)	20X2 dividends	
	($75,000 × .80)	60,000		($40,000 × .80)	32,000
	Balance, 12/31/X2	284,000			

Elimination Entries Needed in the Workpaper

E(31)	Income from Subsidiary	60,000	
	Dividends Declared		32,000
	Investment in Special Foods Stock		28,000
	Eliminate income from subsidiary.		
E(32)	Income to Noncontrolling Interest	14,760	
	Dividends Declared		8,000
	Noncontrolling Interest		6,760
	Assign income to noncontrolling interest:		
	$14,760 = ($75,000 − $1,200) × .20		
E(33)	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(34)	Bonds Payable	100,000	
	Premium on Bonds Payable	1,600	
	Interest Income	13,000	
	Investment in Special Foods Bonds		92,000
	Interest Expense		11,800
	Retained Earnings, January 1		8,640
	Noncontrolling Interest		2,160
	Eliminate intercorporate bond holdings:		
	$1,600 = $2,000 − $200 − $200		
	$13,000 = ($100,000 × .12) + $1,000		
	$92,000 = $91,000 + $1,000		
	$11,800 = ($100,000 × .12) − $200		
	$8,640 = $10,800 × .80		
	$2,160 = $10,800 × .20		

Bonds of Affiliate Purchased from a Nonaffiliate - Illustration

- The impact of the constructive gain on the beginning noncontrolling interest balance and on the beginning consolidated retained earnings balance is reflected in entry E(34)
- Entry E(34) also eliminates all aspects of the intercorporate bond holdings, including:
  - Peerless's investment in bonds
  - Special Foods' bonds payable and the associated premium
  - Peerless's bond interest income
  - Special Foods' bond interest expense

- The amounts related to the bonds from the books of Peerless and Special Foods and the appropriate consolidated amounts are:

Item	Peerless Products	Special Foods	Unadjusted Totals	Consolidated Amounts
Bonds Payable	-0-	$(100,000)	$(100,000)	-0-
Premium on Bonds Payable	-0-	(1,600)	(1,600)	-0-
Investment in Bonds	$ 92,000	-0-	92,000	-0-
Interest Expense	-0-	$ 11,800	$ 11,800	-0-
Interest Income	$(13,000)	-0-	(13,000)	-0-

- The consolidation workpaper prepared for December 31, 20X2, is presented in Figure 8–3 in the text

Bonds of Affiliate Purchased from a Nonaffiliate - Illustration

Peerless's separate income		$173,000
Special Foods' net income	$75,000	
Peerless's amortization of bond discount	(1,000)	
Special Foods' amortization of bond premium	(200)	
Special Foods' realized net income		73,800
Consolidated net income, 20X1		$246,800
Income to noncontrolling interest ($73,800 × .20)		(14,760)
Income to controlling interest		$232,040

Bonds of Affiliate Purchased from a Nonaffiliate - Illustration

Book value of Special Foods, December 31, 20X2:		
Common stock		$200,000
Retained earnings		155,000
Total book value		$355,000
Gain on constructive retirement of bonds	$10,800	
Less: Portion recognized by affiliates during 20X2	(1,200)	
Constructive gain not yet recognized by affiliates		9,600
Realized book value of Special Foods		$364,600
Noncontrolling stockholders' share		× .20
Noncontrolling interest, December 31, 20X2		$ 72,920

Bonds of Affiliate Purchased from a Nonaffiliate - Illustration

- Bond elimination entry in subsequent years
  - In years after 20X2, the workpaper entry to eliminate the intercompany bonds and to adjust for the gain on constructive retirement of the bonds is similar to entry E(34)
  - The unamortized bond discount and premium decrease each year by $1,000 and $200, respectively

Bonds of Affiliate Purchased from a Nonaffiliate - Illustration

- As of the beginning of 20X3, $9,600 of the gain on the constructive retirement of the bonds remains unrecognized by the affiliates:

Gain on constructive retirement of bonds		$10,800
Less: Portion recognized by affiliates during 20X2:		
Peerless's amortization of bond discount	$1,000	
Special Foods' amortization of bond premium	200	
Total gain recognized by affiliates		(1,200)
Unrecognized gain on constructive retirement of bonds, January 1, 20X3		$ 9,600

- In the bond elimination entry in the consolidation workpaper prepared at the end of 20X3, this amount is allocated between beginning retained earnings and the noncontrolling interest

E(35)	Bonds Payable	100,000	
	Premium on Bonds Payable	1,400	
	Interest Income	13,000	
	Investment in Special Foods Bonds		93,000
	Interest Expense		11,800
	Retained Earnings, January 1		7,680
	Noncontrolling Interest		1,920
	Eliminate intercorporate bond holdings:		
	$1,400 = $2,000 − $200 − $200 − $200		
	$13,000 = ($100,000 × .12) + $1,000		
	$93,000 = $91,000 + $1,000 + $1,000		
	$11,800 = ($100,000 × .12) − $200		
	$7,680 = ($10,800 − $1,200) × .80		
	$1,920 = ($10,800 − $1,200) × .20		

- Purchase at an amount greater than book value
  - The consolidation procedures are virtually the same except that a loss is recognized on the constructive retirement of the debt

Special Foods issues 10-year 12 percent bonds on January 1, 20X1, at par of $100,000. The bonds are purchased from Special Foods by Nonaffiliated Corporation, which sells the bonds to Peerless on December 31, 20X1, for $104,500. Special Foods recognizes $12,000 ($100,000 x .12) of interest expense each year. Peerless recognizes interest income of $11,500 in each year after 20X1:

Annual cash interest payment ($100,000 × .12)	$12,000
Less: Amortization of premium on bond investment ($4,500 ÷ 9 years)	(500)
Interest income	$11,500

Because the bonds were issued at par, the carrying amount on Special Foods' books remains at $100,000. Thus, once Peerless purchases the bonds from Nonaffiliated Corporation for $104,500, a loss on the constructive retirement must be recognized in the consolidated income statement for $4,500.

The bond elimination entry in the consolidation workpaper prepared at the end of 20X1 removes the bonds payable and the bond investment and recognizes the loss on the constructive retirement:

E(36)	Bonds Payable	100,000	
	Loss on Bond Retirement	4,500	
	Investment in Special Foods Bonds		104,500
	Eliminate intercorporate bond holdings.		

The bond elimination entry needed in the consolidation workpaper prepared at the end of 20X2 is as follows:

E(37)	Bonds Payable	100,000	
	Interest Income	11,500	
	Retained Earnings, January 1	3,600	
	Noncontrolling Interest	900	
	Investment in Special Foods Bonds		104,000
	Interest Expense		12,000
	Eliminate intercorporate bond holdings:		
	$11,500 = ($100,000 × .12) − $500		
	$3,600 = $4,500 × .80		
	$900 = $4,500 × .20		
	$104,000 = $104,500 − $500		
	$12,000 = $100,000 × .12		

Similarly, the following entry is needed in the consolidation workpaper at the end of 20X3:

E(38)	Bonds Payable	100,000	
	Interest Income	11,500	
	Retained Earnings, January 1	3,200	
	Noncontrolling Interest	800	
	Investment in Special Foods Bonds		103,500
	Interest Expense		12,000
	Eliminate intercorporate bond holdings:		
	$\$3,200 = (\$4,500 - \$500) \times .80$		
	$\$800 = (\$4,500 - \$500) \times .20$		
	$\$103,500 = \$104,500 - \$500 - \$500$		

THANK YOU