Intercompany Profit Transactions - Inventories

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GENERAL OVERVIEW

- When there have been intercompany inventory transactions, eliminating entries are needed to remove the revenue and expenses related to the intercompany transfers recorded by the individual companies
- The eliminations ensure that only the cost of the inventory to the consolidated entity is included in the consolidated balance sheet when the inventory is still on hand and is charged to cost of goods sold in the period the inventory is resold to nonaffiliates

Transfers at cost

- The balance sheet inventory amounts at the end of the period require no adjustment for consolidation because the purchasing affiliate's inventory carrying amount is the same as the cost to the transferring affiliate and the consolidated entity
- When inventory is resold to a nonaffiliate, the amount recognized as cost of goods sold by the affiliate making the outside sale is the cost to the consolidated entity

- An eliminating entry is needed to remove both the revenue from the intercorporate sale and the related cost of goods sold recorded by the seller
- Consolidated net income is not affected by the eliminating entry

- Companies use different approaches in setting intercorporate transfer prices
- The elimination process must remove the effects of such sales from the consolidated statements

Transfers at a profit or loss

- The workpaper eliminations needed for consolidation in the period of transfer must adjust accounts in:
  - Consolidated income statement: Sales and cost of goods sold
  - Consolidated balance sheet: Inventory
- The resulting financial statements appear as if the intercompany transfer had not occurred

- Most companies use either a perpetual or a periodic inventory control system to keep track of inventory and cost of goods sold
- The choice between these inventory systems results in different entries on the books of the individual companies and, therefore, slightly different workpaper eliminating entries in preparing consolidated financial statements

DOWNSTREAM SALE OF INVENTORY

- For consolidation purposes, profits recorded on an intercorporate inventory sale are recognized in the period in which the inventory is resold to an unrelated party
  - Until the point of resale, all intercorporate profits must be deferred
  - When a company sells an inventory item to an affiliate, one of three situations results:
    1. The item is resold to a nonaffiliate during the same period
    2. The item is resold to a nonaffiliate during the next period
    3. The item is held for two or more periods by the purchasing affiliate

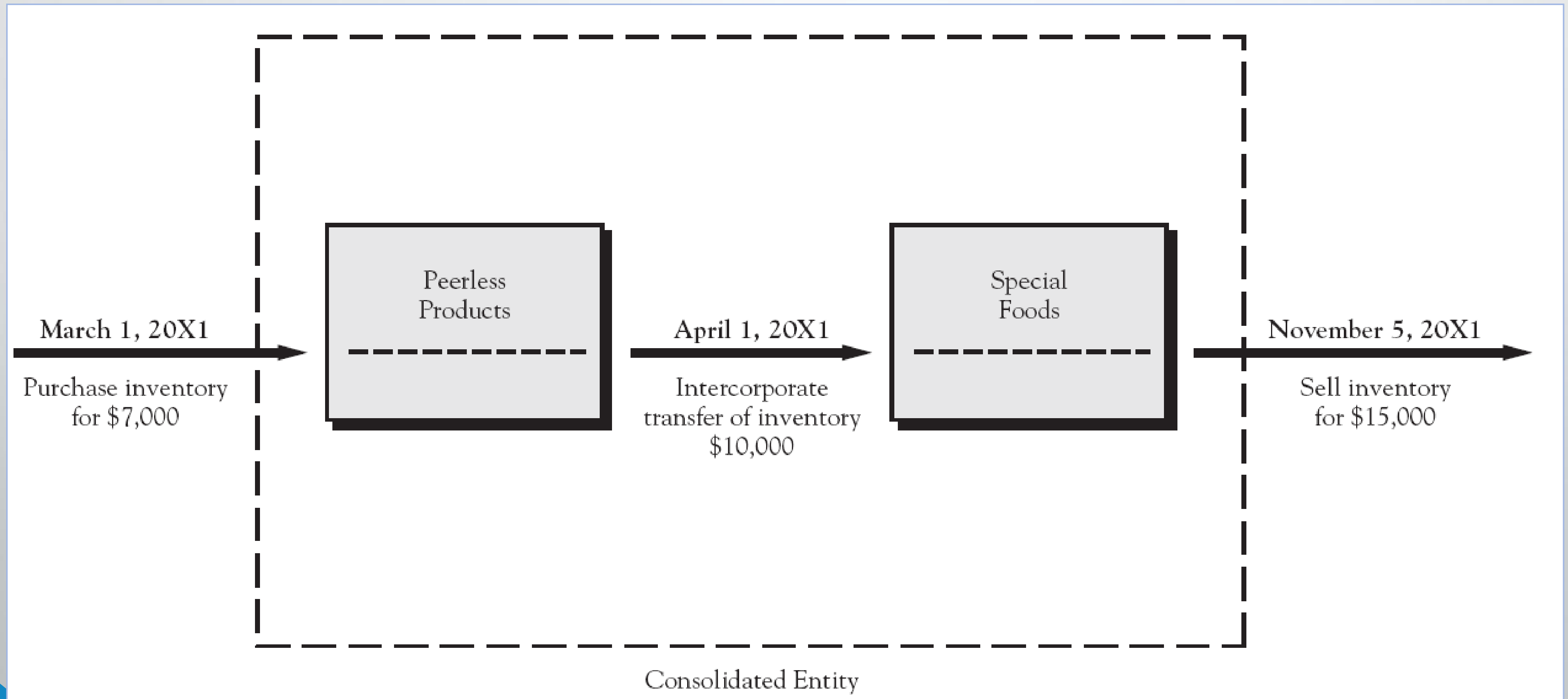
Downstream Sale of Inventory - Illustration

Peerless Products acquires 80 percent of the common stock of Special Foods on December 31, 20X0, for its book value of $240,000. The fair value of noncontrolling interest on that date is equal to its book value of $60,000. On March 1, 20X1, Peerless buys inventory for $7,000 and resells it to Special Foods for $10,000 on April 1.

Peerless records the following entries on its books:		
March 1, 20X1		
Inventory	**7,000**	
Cash		**7,000**
Purchase of inventory.		
April 1, 20X1		
Cash	**10,000**	
Sales		**10,000**
Sale of inventory to Special Foods.		
Cost of Goods Sold	**7,000**	
Inventory		**7,000**
Cost of inventory sold to Special Foods.		
Special Foods records the purchase of the inventory:		
April 1, 20X1		
Inventory	**10,000**	
Cash		**10,000**
Purchase of inventory from Peerless.		

Downstream Sale of Inventory - Illustration

- Resale in period of intercorporate transfer



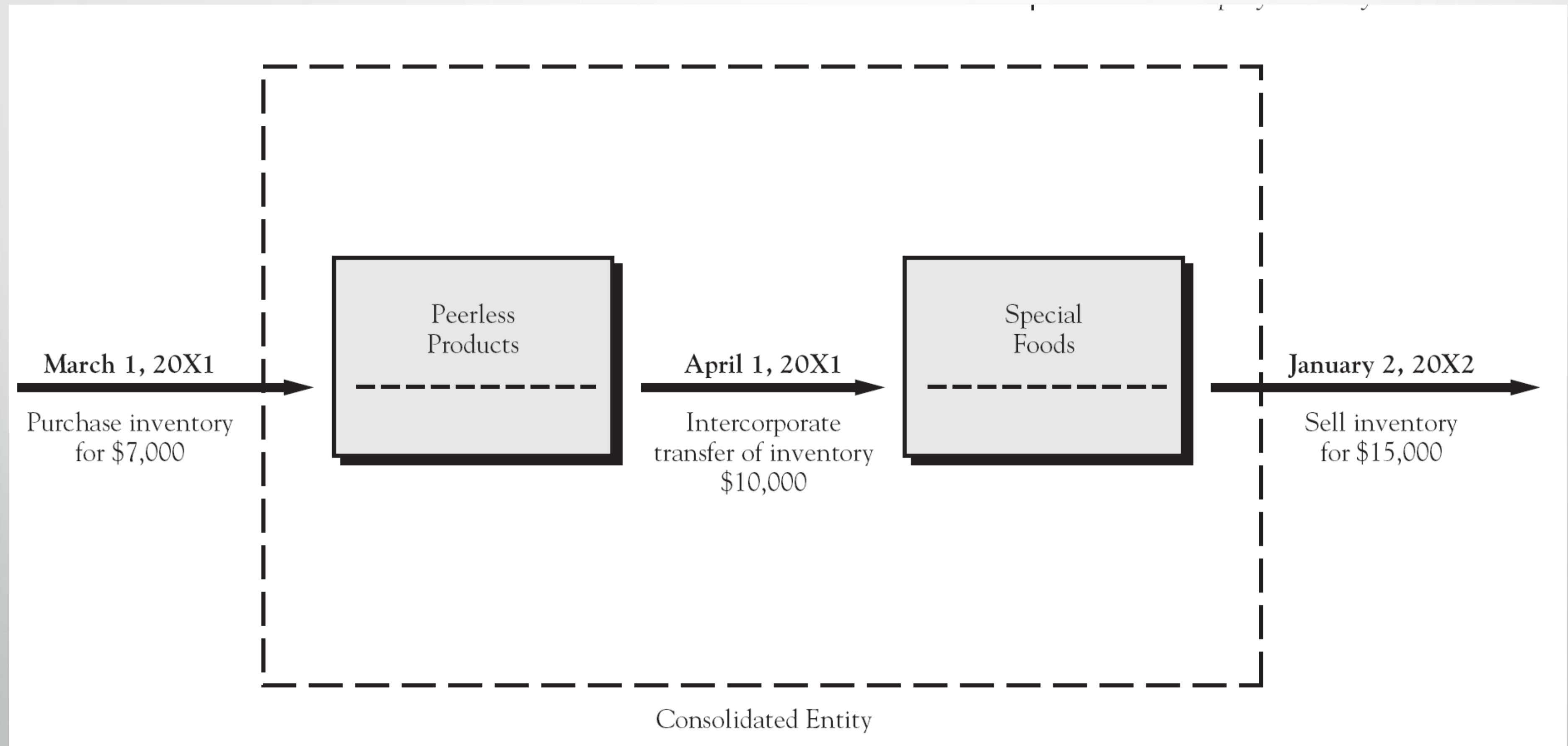
Downstream Sale of Inventory - Illustration

Special Foods records the sale:		
November 5, 20X1		
Cash	**15,000**	
Sales		**15,000**
Sale of inventory to Nonaffiliated.		
Cost of Goods Sold	**10,000**	
Inventory		**10,000**
Cost of inventory sold to Nonaffiliated.		
Eliminating Entry:		
Sales	**10,000**	
Cost of Goods Sold		**10,000**
Eliminate intercompany inventory sale.		

- This entry does not affect consolidated net income
- No elimination of intercompany profit is needed because all the intercompany profit has been realized through resale of the inventory to the external party during the current period

Downstream Sale of Inventory - Illustration

- Resale in period following intercorporate transfer



Using the basic equity method, Peerless records its share of Special Foods' income and dividends for 20X1 in the normal manner:

Cash	**24,000**	
Investment in Special Foods Stock		**24,000**
Record dividends from Special Foods: $30,000 x .80		
Investment in Special Foods Stock	**40,000**	
Income from Subsidiary		**40,000**
Record equity-method income: $50,000 x .80		

As a result of these entries, the ending balance of the investment account is $256,000 ($240,000 + $40,000 - $24,000).

The consolidation workpaper prepared at the end of 20X1 appears in Figure 7–1 of the text.

Eliminating Entries:

Entry	Account	Debit	Credit
E(10)	**Income from Subsidiary**	**40,000**	
	Dividends Declared		**24,000**
	Investment in Special Foods Stock		**16,000**
	Eliminate income from subsidiary.		
E(11)	**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(12)	**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(13)	**Sales**	**10,000**	
	Cost of Goods Sold		**7,000**
	Inventory		**3,000**
	Eliminate intercompany downstream sale of inventory.		

Only entry E(13) relates to the elimination of unrealized inventory profits

Downstream Sale of Inventory - Illustration

- Consolidated Net Income—20X1

Peerless's separate income	$140,000
Less: Unrealized intercompany profit on downstream inventory sale	(3,000)
Peerless's separate realized income	$137,000
Special Foods' net income	50,000
Consolidated net income, 20X1	$187,000
Income to noncontrolling interest ($50,000 × .20)	(10,000)
Income to controlling interest	$177,000

During 20X2, Special Foods receives $15,000 when it sells to Nonaffiliated Corporation the inventory that it had purchased for $10,000 from Peerless in 20X1. Also, Peerless records its pro rata portion of Special Foods' net income and dividends for 20X2 with the normal basic equity-method entries:

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

The consolidation workpaper prepared at the end of 20X2 is shown in Figure 7–2 in the text. Four elimination entries are needed:

Downstream Sale of Inventory - Illustration

Investment in Special Foods Stock					
	Original cost	240,000			
(9)	20X1 Equity accrual		(8)	20X1 Dividends	
	($50,000 × .80)	40,000		($30,000 × .80)	24,000
	Balance, 12/31/X1	256,000			
(15)	20X2 Equity accrual		(14)	20X2 Dividends	
	($75,000 × .80)	60,000		($40,000 × .80)	32,000
	Balance, 12/31/X2	284,000			

Downstream Sale of Inventory - Illustration

Eliminating Entries:			
E(16)	**Income from Subsidiary**	**60,000**	
	Dividends Declared		**32,000**
	Investment in Special Foods Stock		**28,000**
	Eliminate income from subsidiary.		
E(17)	**Income to Noncontrolling Interest**	**15,000**	
	Dividends Declared		**8,000**
	Noncontrolling Interest		**7,000**
	Assign income to noncontrolling interest. $15,000 = $75,000 x .20		
E(18)	**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(19)	**Retained Earnings, January 1**	**3,000**	
	Cost of Goods Sold		**3,000**
	Eliminate beginning inventory profit.		

Entry E(19) is needed to adjust cost of goods sold to the proper consolidated balance and to reduce beginning retained earnings.

Downstream Sale of Inventory - Illustration

- Consolidated Net Income—20X2

Peerless's separate income	$160,000
Realization of deferred intercompany profit on downstream inventory sale	3,000
Peerless's separate realized income	$163,000
Special Foods' net income	75,000
Consolidated net income, 20X2	$238,000
Income to noncontrolling interest ($75,000 × .20)	(15,000)
Income to controlling interest	$223,000

- Inventory held two or more periods
  - Prior to liquidation, an eliminating entry is needed in the consolidation workpaper each time consolidated statements are prepared to restate the inventory to its cost to the consolidated entity

For example, if Special Foods continues to hold the inventory purchased the following eliminating entry is needed in the consolidation workpaper each time a consolidated balance sheet is prepared for years following the year of intercompany sale, for as long as the inventory is held:

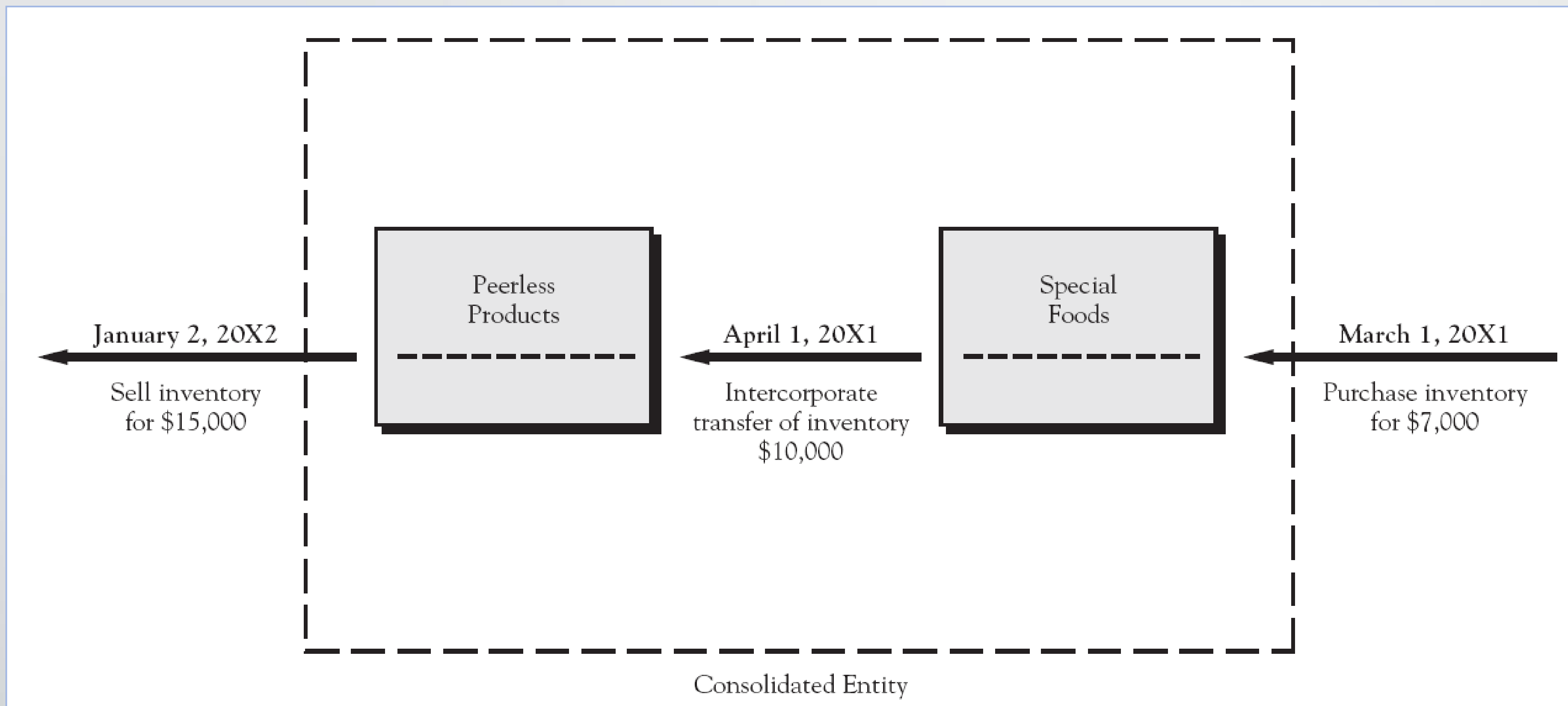
		Debit	Credit
E(20)	**Retained Earnings, January 1**	**3,000**	
	Inventory		**3,000**
	Eliminate beginning inventory profit.		

UPSTREAM SALE OF INVENTORY

When an upstream sale of inventory occurs and the inventory is resold by the parent to a nonaffiliate during the same period, all the parent's equity-method entries and the eliminating entries in the consolidation workpaper are identical to those in the downstream case

Upstream Sale of Inventory

When the inventory is not resold to a nonaffiliate before the end of the period, workpaper eliminating entries are different from the downstream case only by the apportionment of the unrealized intercompany profit to both the controlling and noncontrolling interests



20X1: Peerless records the following basic equity-method entries:		
Cash	24.000	
Investment in Special Foods Stock		24.000
Record dividends from Special Foods: $30,000 x .80		
Investment in Special Foods Stock	40.000	
Income from Subsidiary		40.000
Record equity-method income: $50,000 x .80		

Eliminating Entries:

		Debit	Credit
E(23)	**Income from Subsidiary**	**40,000**	
	Dividends Declared		**24,000**
	Investment in Special Foods Stock		**16,000**
	Eliminate income from subsidiary.		
E(24)	**Income to Noncontrolling Interest**	**9,400**	
	Dividends Declared		**6,000**
	Noncontrolling Interest		**3,400**
	Assign income to noncontrolling interest: $9,400 = ($50,000 - $3,000) x .20		
E(25)	**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(26)	**Sales**		
	Cost of Goods Sold	**3,000**	**7,000**
	Inventory		**3,000**
	Eliminate intercompany upstream sale of inventory.		

All eliminating entries are the same in the upstream case as in the downstream case except for entry E(24).
Refer Figure 7-3 in the text for the Consolidation Workpaper.

- Consolidated Net Income—20X1

Peerless's separate income		$140,000
Special Foods' net income	$50,000	
Less: Unrealized intercompany profit on upstream inventory sale	(3,000)	
Special Foods' realized net income		47,000
Consolidated net income, 20X1		$187,000
Income to noncontrolling interest ($47,000 × .20)		(9,400)
Income to controlling interest		$177,600

Basic Equity-Method Entries—20X2

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

As in the downstream illustration, the investment account balance at the end of 20X2 is $284,000.

The consolidation workpaper used to prepare consolidated financial statements at the end of 20X2 appears in Figure 7–4 in the text.

Eliminating Entries:			
E(29)	**Income from Subsidiary**	**60,000**	
	Dividends Declared		**32,000**
	Investment in Special Foods Stock		**28,000**
	Eliminate income from subsidiary.		
(E30)	**Income to Noncontrolling Interest**	**15,600**	
	Dividends Declared		**8,000**
	Noncontrolling Interest		**7,600**
	Assign income to noncontrolling interest: $15,600 = ($75,000 - $3,000) x .20		
E(31)	**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(32)	**Retained Earnings, January 1**	**2,400**	
	Noncontrolling Interest	**600**	
	Cost of Goods Sold		**3,000**
	Eliminate beginning inventory profit: $2,400 = $3,000 x .80 $600 = $3,000 x .20		

Workpaper entry E(32) deals explicitly with the elimination of the inventory profit on the upstream sale.

Upstream Sale of Inventory - Illustration

- Consolidated Net Income—20X2

Peerless's separate income		$160,000
Special Foods' net income	$75,000	
Realization of deferred intercompany profit on upstream inventory sale	3,000	
Special Foods' realized net income		78,000
Consolidated net income, 20X2		$238,000
Income to noncontrolling interest ($78,000 × .20)		(15,600)
Income to controlling interest		$222,400

ADDITIONAL CONSIDERATIONS

Sale from one subsidiary to another

- Transfers of inventory often occur between companies that are under common control or ownership
- The eliminating entries are identical to those presented earlier for sales from a subsidiary to its parent
- The full amount of any unrealized intercompany profit is eliminated, with the profit elimination allocated proportionately against the ownership interests of the selling subsidiary

- When one affiliate transfers inventory to another, some additional cost is often incurred
- Such costs should be treated in the same way as if the affiliates were operating divisions of a single company

- A company might write down inventory purchased from an affiliate under this rule if the market value at the end of the period is less than the intercompany transfer price

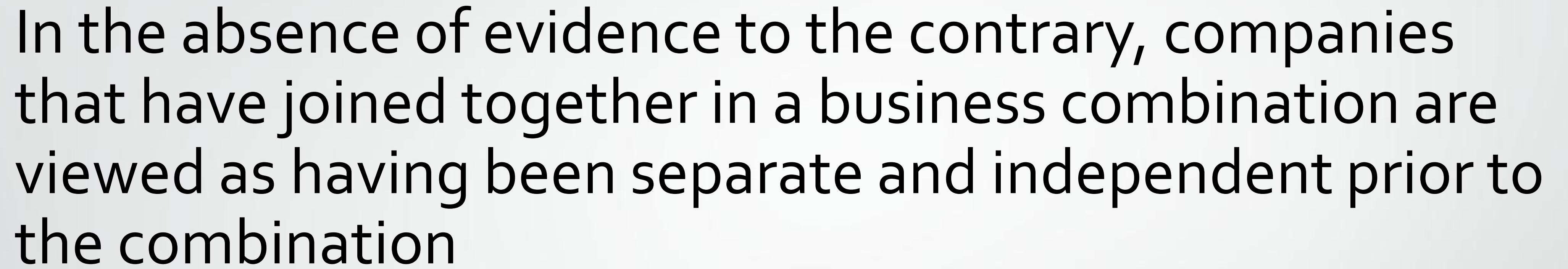
Assume that a parent company purchases inventory for $20,000 and sells it to its subsidiary for $35,000. The subsidiary still holds the inventory at year-end and determines that its market value (replacement cost) is $25,000 at that time. The subsidiary writes the inventory down from $35,000 to its lower market value of $25,000 at the end of the year and records the following entry:

	Debit	Credit
Loss on Decline in Value of Inventory	**10,000**	
Inventory		**10,000**
Write down inventory to market value.		

The following eliminating entry is needed in the consolidation workpaper:

		Debit	Credit
E(34)	**Sales**	**35,000**	
	Cost of Goods Sold		**20,000**
	Inventory		**5,000**
	Loss on Decline in Value of Inventory		**10,000**
	Eliminate intercompany sale of inventory.		

- The consolidation treatment of profits on inventory transfers that occurred before the business combination depends on whether the companies were at that time independent and the sale transaction was the result of arm's-length bargaining
- As a general rule, the effects of transactions that are not the result of arm's-length bargaining must be eliminated



In the absence of evidence to the contrary, companies that have joined together in a business combination are viewed as having been separate and independent prior to the combination

- If the prior sales were the result of arm’s-length bargaining, they are viewed as transactions between unrelated parties
- No elimination or adjustment is needed in preparing consolidated statements subsequent to the combination, even if an affiliate still holds the inventory

THANK YOU