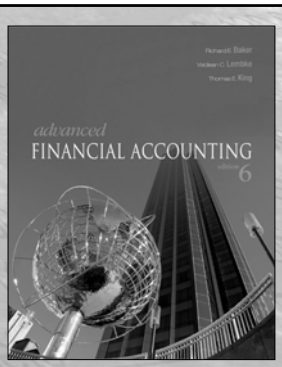


Chapter 6

Intercorporate Transfers: Noncurrent Assets

McGraw-Hill/Irwin

Intercorporate Transfers

- A parent company and its subsidiaries often engage in a variety of transactions among themselves.
- For example, manufacturing companies often have subsidiaries that develop raw materials or produce components to be included in the products of affiliated companies.
- These transactions between related companies are referred to as ***intercorporate transfers*.**

Intercorporate Transfers

- The central idea of consolidated financial statements is that they report on the activities of the consolidating affiliates as if the separate affiliates actually constitute a single company.
- Because single companies are not permitted to reflect internal transactions in their financial statements, consolidated entities also must exclude from their financial statements the effects of transactions that are contained totally within the consolidated entity.

Intercorporate Transfers

- Building on the basic consolidation procedures presented in earlier chapters, this chapter and the next two deal with the effects of intercorporate transfers.
- This chapter deals with intercorporate services (e.g., consulting) and sales of fixed assets, while intercorporate sales of inventory and intercorporate debt transfers are discussed in Chapters 7 and 8, respectively.

Intercorporate Transfers

- All aspects of intercorporate transfers must be eliminated in preparing consolidated financial statements so that the statements appear as if they were those of a single company.
- **ARB 51** mentions open account balances, security holdings, sales and purchases, and interest and dividends as examples of the intercompany balances and transactions that must be eliminated.

Intercorporate Transfers

- The focus in consolidation is on the single-entity concept rather than on the percentage of ownership.
- Once the conditions for consolidation are met, a company becomes part of a single economic entity and all transactions with related companies become internal transfers that must be eliminated fully, regardless of the level of ownership held.

Unrealized Profits and Losses

- Profit of 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, but the profit is not considered realized for consolidation purposes until confirmed, usually through resale to an unrelated party.
- This unconfirmed profit from an intercorporate transfer is referred to as ***unrealized intercompany profit.***

6-7

Unrealized Profits and Losses

- From a consolidated viewpoint, the sale of an asset wholly within the consolidated entity involves only a change in the location of the asset and does not represent the culmination of the earning process.
- To culminate the earning process with respect to the consolidated entity, a sale must be made to a party external to the consolidated party.

6-8

Unrealized Profits and Losses

- The key to deciding when to report a transaction in the consolidated financial statements is to visualize the consolidated entity and determine whether a particular transaction occurs totally with the consolidated entity, in which case its effects must be excluded from the consolidated statements, or involves outsiders and thus constitutes a transaction of the consolidated entity.

6-9

Asset Transfers Involving Land

- When intercorporate transfers of noncurrent assets occur, adjustments often are needed in the preparation of consolidated financial statements for as long as the assets are held by the acquiring company.
- The simplest example of an intercorporate asset transfer is the intercorporate sale of land.

6-10

Transfer of Land at Book Value

- When land is transferred between related companies at book value, no special adjustments or eliminations are needed in preparing the consolidated statements.
- Because no gain or loss is recorded by the seller both income and assets are stated correctly from a consolidated viewpoint.

6-11

Transfer of Land at a Gain or Loss

- Land transfers at more or less than book value do require special treatment in the consolidation process.
- The selling entity's gain or loss must be eliminated because the land is still held by the consolidated entity, and no gain or loss may be reported in the consolidated financial statements until the land is sold to a party outside the consolidated entity. [Continued on next slide.]

6-12

Transfer of Land at a Gain or Loss

- Likewise, 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.

6-13

Example

- Assume that one affiliate sells land to another affiliate for $15,000 more than book value. The intercorporate transfer causes the seller to recognize a $15,000 gain and the carrying value of the land to increase by the same amount.
- Neither of these amounts may be reported in the consolidated financial statements because the $15,000 intercompany gain is unrealized from a consolidated viewpoint.

6-14

Example-Continued

The land has not been sold to a party outside the consolidated entity but only transferred within; consequently, the land must continue to be reported at its original cost to the consolidated entity. The gain must be eliminated in the preparation of consolidated financial statements and the land restated to its original cost as follows:

Gain on Sale of Land	15,000	
Land		15,000

6-15

Unrealized Profit Elimination

- Generally, gains and losses are not considered realized by the consolidated entity until a sale is made to an external party.
- Unrealized gains and losses are eliminated in preparing consolidated financial statements against the interests of those shareholders who recognized the gains and losses in the first place— the shareholders of the selling affiliate.
- Therefore, the direction of the sale determines which shareholder group absorbs the elimination of unrealized intercompany gains and losses.

6-16

Unrealized Profit Elimination

- 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 stockholders of the parent company.
- When a sale is from a subsidiary to its parent, an ***upstream sale,*** any gain or loss accrues to the stockholders of the subsidiary.

6-17

Unrealized Profit Elimination

- If the subsidiary is wholly owned, all the gain or loss ultimately accrues to the parent company as the sole stockholder.
- If, however, 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.

6-18

Unrealized Profit Elimination

- If the sale is a downstream transfer, all the unrealized profit is eliminated from the controlling interest's share of income when consolidated statements are prepared.
- If, instead, the intercompany transfer is from subsidiary to parent, the unrealized profit on the upstream sale is eliminated proportionately from the interests of the controlling and noncontrolling shareholders.

6-19

Unrealized Profit Elimination

- For example, assume that the unrealized gain is $10,000 and the parent owns 75% of the subsidiary.
- Consolidated net income is $2,500 greater in the upstream case because 25% of the unrealized profit elimination is deducted from the noncontrolling interest rather than deducting the full amount from the controlling interest as in the downstream case.

6-20

Unrealized Profit Elimination

- Note that unrealized intercompany gains and losses are always fully eliminated in preparing consolidated financial statements.
- The existence of a noncontrolling interest in a selling subsidiary affects only the allocation of the eliminated unrealized gain or loss and not the amount eliminated.

6-21

Elimination after the First Year

- In the period in which unrealized profit arise from an intercorporate sale, workpaper eliminating entries are used in the consolidation process to remove the gain or loss recorded by the seller and to adjust the reported amount of the asset back to the price originally paid by the selling affiliate.
- Each period thereafter while the asset is held by the purchasing affiliate, the reported asset balance and the shareholder claims of the selling affiliate are adjusted to remove the effects of the unrealized gain or loss.

6-22

Elimination after the First Year

- In the case of a downstream sale, the profit on the intercompany transfer is recognized entirely by the parent and is included in the parent's retained earnings in subsequent years.
- Therefore, 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 land is held by the subsidiary:

Retained Earnings, January 1	$15,000	
Land		$15,000

6-23

Elimination after the First Year

- In the upstream case, the intercompany profit is recognized by the subsidiary. The parent recognizes its proportionate share of the gain, and that amount is included in the parent's beginning retained earnings in the subsequent years. The unrealized intercompany gain is eliminated from the reported balance of the land and proportionately from the subsidiary ownership interests with the following entry:

Retained Earnings, January 1	**$12,000**	
Noncontrolling Interest	**$3,000**	
Land		**$15,000**

6-24

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.
- For consolidation purposes, the gain or loss recognized by the affiliate selling to the external party must be adjusted for the previously unrealized intercompany gain or loss.

6-25

Subsequent Disposition of Asset

- 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, which is the cost incurred by the affiliate that purchased the asset originally from an outside party.

6-26

Subsequent Disposition of Asset

- When previously unrealized intercompany profits are realized, the effects of the profit elimination process must be reversed.
- At the time of realization, the full amount of the deferred intercompany profit is added back into the consolidated income computation and assigned to the shareholder interests from which it originally was eliminated.

6-27

Subsequent Disposition of Asset

- In the consolidation workpaper, the land no longer needs to be reduced by the unrealized intercompany gain because the gain now is realized and the land no longer is held by the consolidated entity. The following eliminating entry is made in the consolidation workpaper prepared in the year that the land is resold to external parties:

Retained Earnings, January 1	$15,000	
Gain on Sale of Land		$15,000

6-28

Transfers Involving 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.
- In effect, a portion of the unrealized gain or loss is realized each period as benefits are derived from the asset and its service potential expires.

6-29

Transfers Involving Depreciable Assets

- The amount of depreciation recognized on a company's books each period on an asset purchased from an affiliate is based on the intercorporate transfer price.
- From a consolidated viewpoint, however, depreciation must be based on the cost of the asset to the consolidated entity, which is the cost of the asset to the related company that originally purchased it from an outsider.

6-30

Transfers Involving Depreciable Assets

- Eliminating entries are needed in the consolidation workpaper to restate the asset, associated accumulated depreciation, and depreciation expense to the amounts that would appear in the financial statements if there had been no intercompany transfer.
- Because the intercompany sale takes place totally within the consolidated entity, the consolidated financial statements must appear as if the intercompany transfer had never occurred.

6-31

Downstream Sale

- Parent sells equipment to Subsidiary on December 31, 20X1 for $7,000. The equipment was purchased by Parent three years earlier at a cost of $9,000. Depreciation on the equipment was calculated based on a total life of ten years using straight-line depreciation with no residual value.
- Continued on next slide.

6-32

Consolidation Entry

The following entry is needed to eliminate the effects of the intercompany transaction in the year of the transfer (i.e., 20X1):

Buildings and Equipment (9,000-7,000)	**$2,000**	
Gain on Sale of Equipment	**$700**	
Accumulated Depreciation		**$2,700 ***

*** $2,700 = (9,000)(0.10)(3)**

Eliminate unrealized gain on downstream sale of equipment (and restate the related accounts "as if" the transfer never took place).

6-33

Consolidation Entry

The following entry is needed to eliminate the effects of the 20X1 intercompany transaction as of the beginning of 20X2:

Buildings and Equipment (9,000-7,000)	**$2,000**	
Retained Earnings, January 1	**$700**	
Accumulated Depreciation		**$2,700 ***

*** $2,700 = (9,000)(0.10)(3)**

Eliminate unrealized gain on downstream sale of equipment (and restate the related accounts "as if" the transfer never took place).

6-34

Change in Estimated Life of Asset

- When a depreciable asset is transferred between companies, a change in the remaining estimated economic life may be appropriate.
- For example, the acquiring company may use the asset in a different type of production process, or the frequency of use may change.

6-35

Change in Estimated Life of Asset

- When a change in the estimated life of a depreciable asset occurs at the time of an intercorporate 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.

6-36

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.

6-37

Consolidation Entry

The case of an upstream sale can be illustrated using the same facts as for the previous downstream example.

Buildings and Equipment (9,000-7,000)	**$2,000**	
Retained Earnings, January 1 (0.8)(700)	**$560**	
Noncontrolling Interest (0.2)(700)	**$140**	
Accumulated Depreciation		**$2,700**

Eliminate unrealized gain on upstream sale of equipment at the beginning of year 20X2 (and to restate the related accounts "as if" the transfer never took place).

6-38

Intercompany Transfers of Services

- Related companies frequently purchase services from one another.
- These services may be of many different types, but intercompany purchases of consulting, engineering, marketing, and maintenance services are common.

6-39

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.
- When consolidated financial statements are prepared, both the expense and revenue must be eliminated.

6-40

Intercompany Transfers of Services

- For example, if the parent sells consulting services to the subsidiary for $50,000, the parent would recognize $50,000 of consulting revenue on its books and the subsidiary would recognize $50,000 of consulting expense.
- In the consolidation workpaper, an eliminating entry would be needed to reduce both consulting revenue (debit) and consulting expense (credit) by $50,000.

6-41

Intercompany Transfers of Services

- Because the revenue and expense are equal and both are eliminated, income is unaffected by the elimination.
- Even though income is not affected, the elimination is still important, however, because otherwise both revenues and expenses are overstated.

6-42

Intercompany Transfers of Services

- Generally, a simplistic approach is taken in eliminating intercompany transfers of services by assuming that the services benefit the current period and, therefore, any intercompany profit on the services becomes realized within the period of transfer.
- Accordingly, no eliminating entries relating to the current period's transfer of services are needed in future periods because the intercompany profit is considered realized in the transfer period.

6-43

Intercompany Transfers of Services

- Usually the assumption that the profit on intercompany sales of services is realized in the period of sale is not an unrealistic assumption.
- In some cases, however, realization of intercompany profit on the services does not occur in the period the services are provided and the amounts are significant. For example, if the parent company charges a subsidiary for architectural services to design a new manufacturing facility for the subsidiary, the subsidiary would include that cost in the capitalized cost of the new facility.

6-44

Intercompany Transfers of Services

- From a consolidated point of view, however, any profit the parent recognized on the intercompany sale of services (revenue over the cost of providing the service) would have to be eliminated from the reported cost of the new facility until the intercompany profit became realized.
- Realization would be viewed as occurring over the life of the facility. Thus, eliminating entries would be needed each similar to intercompany transfers of fixed assets.

6-45

Transfers Involving Amortizable Assets

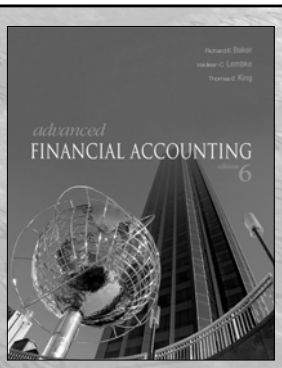
- Production rights, patents, and other types of intangible assets may be sold to affiliated enterprises.
- Amortizable intangibles normally are reported at the remaining unamortized balance without the use of a contra account.
- Other than netting the accumulated amortization on an intangible asset against the asset cost, the intercompany sale of intangibles is treated the same in consolidation as the intercompany sale of tangible assets.

6-46

You Will Survive This Chapter!!!

- FYI: In your auditing classes, transactions between affiliated parties are referred to as Related Party Transactions (RPTs).

6-47



Chapter 6

End of Chapter