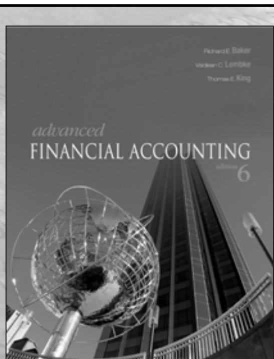


Chapter 8

Intercompany Indebtedness

Intercompany Indebtedness

- One advantage of having control over other companies is that management has the ability to transfer resources from one legal entity to another as needed by the individual companies.
- Companies often find it beneficial to lend excess funds to affiliates and to borrow from affiliates when cash shortages arise.

Intercompany Indebtedness

- The borrower often benefits from lower borrowing rates, less restrictive credit terms, and the informality and lower debt issue costs of intercompany borrowing relative to public debt offerings.
- The lending affiliate may benefit by being able to invest excess funds in a company about which it has considerable knowledge, perhaps allowing it to earn a given return on the funds invested while incurring less risk than if it invested in unrelated companies.

Intercompany Indebtedness

- The combined entity may find it advantageous for the parent company or another affiliate to borrow funds for the entire enterprise rather than having each affiliate going directly to the capital markets.
- This chapter discusses the procedures used to prepare consolidated financial statements when intercorporate indebtedness arises from either direct or indirect debt transfer.

Consolidation Overview

- A direct intercompany debt transfer involves a loan from one affiliate to another without the participation of an unrelated party.
- Examples include a trade receivable/payable arising from an intercompany sale of inventory on credit, and the issuance of a note payable by one affiliate to another in exchange for operating funds.

Consolidation Overview

- 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.
- For example, Special Foods borrows funds by issuing a debt instrument, such as a note or a bond, to Nonaffiliated Corporation. The debt instrument subsequently is purchased from Nonaffiliated Corporation by Special Foods' parent, Peerless Products. Thus, Peerless Products acquires the debt of Special Foods indirectly through Nonaffiliated Corporation.

Consolidation Overview

- All account balances arising from intercorporate financing arrangements must be eliminated when consolidated statements are prepared.
- Although the discussion focuses on bonds, the same concepts and procedures also apply to notes and other types of intercorporate indebtedness.

8-7

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.
- A company cannot report an investment in its own bonds or a bond liability to itself.

8-8

Bond Sale Directly to an Affiliate

- Thus, when the consolidated entity is viewed as a single company, all amounts associated with the intercorporate indebtedness must be eliminated, including the investment in bonds, the bonds payable, any unamortized discount or premium on the bonds, the interest income and expense on the bonds, and any accrued interest receivable and payable.

8-9

Transfer at Par Value

- When a note or bond payable is sold directly to an affiliate at par value, the entries recorded by the investor and the issuer should be mirror images of each other.
- Three elimination entries are needed in the consolidation workpaper to remove the effects of the intercompany indebtedness:

8-10

Transfer at Par Value

• Bonds Payable	$100,000	
Investment in Bonds		$100,000

Eliminate intercorporate bond holding ($100,000 assumed).

• Interest Income	$12,000	
Interest Expense		$12,000

Eliminate intercompany interest – income statement ($12,000 assumed).

• Interest Payable	$16,000	
Interest Receivable		$16,000

Eliminate intercompany interest – balance sheet ($16,000 assumed).

8-11

Transfer at Par Value

- These entries eliminate from the consolidated statements the bond investment and associated income recorded on the investor's books and the liability and related interest expense recorded on the issuer's books. Thus, the resulting statements appear as if the indebtedness does not exist, which from a consolidated viewpoint it does not.
- Note that these entries have no effect on consolidated net income because they reduce interest income and interest expense by the same amount.

8-12

Transfer at a Discount or Premium

- When the coupon or nominal interest rate on a bond is different from the yield demanded by those who lend funds, a bond will sell at a discount or premium.
- In such cases, the amount of bond interest income or expense recorded no longer is equal to the cash interest payment.
- Instead, interest income and expense amounts are adjusted for the amortization of the discount or premium.

8-13

Transfer at a Discount

- Recall that the amortization of the bond discount by the debtor causes interest expense to be greater than the cash interest payment and causes the balance of the discount to decrease.
- Also, recall that the amortization of the discount by the bond investor increases interest income to an amount greater than the cash interest payment and causes the balance of the bond investment account to increase.

8-14

Elimination - Discount

- The following eliminating entries related to the intercompany bond holdings (discount assumed; all amounts are assumed):

• Bonds Payable	$100,000	
Investment in Bonds		$91,000
Discount on Bonds Payable		$9,000
• Interest Payable	$13,000	
Interest Expense		$13,000
• Interest Payable	$6,000	
Interest Receivable		$6,000

8-15

Transfer at Premium

- Recall that the amortization of the bond premium by the debtor causes interest expense to be lesser than the cash interest payment and causes the balance of the premium to decrease.
- Also, recall that the amortization of the premium by the bond investor decreases interest income to an amount less than the cash interest payment and causes the balance of the bond investment account to decrease.

8-16

Elimination - Premium

- The following eliminating entries related to the intercompany bond holdings (premium assumed; all amounts are assumed):

• Bonds Payable	$100,000	
Premium on Bonds Payable	$10,000	
Investment in Bonds		$110,000
• Interest Payable	$13,000	
Interest Expense		$13,000
• Interest Payable	$6,000	
Interest Receivable		$6,000

8-17

Upstream versus Downstream

- With respect to intercompany indebtedness, “upstream” elimination entries are different from the “downstream” case only by the apportionment of the constructive gain or loss (discussed next) to both the controlling and noncontrolling interests.

8-18

Bonds Acquired from a Nonaffiliate

- 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.

8-19

Bonds Acquired from a Nonaffiliate

- 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 in acquiring the bonds.

8-20

Bonds Acquired from a Nonaffiliate

- When a constructive retirement occurs, neither the bonds payable nor the purchaser's investment in the bonds is reported in the consolidated balance sheet because the bonds no longer are considered outstanding.

8-21

Purchase at Book Value

- In the event that a company purchases the debt of an affiliate from an unrelated party at a price equal to the liability reported by the debtor, the elimination entries required in preparing the consolidated financial statements are identical to those used in eliminating a direct intercorporate debt transfer.

8-22

Purchase at Book Value

- In this case, the total of the bond liability and the related premium or discount reported by the debtor will equal the balance in the investment account shown by the bondholder, and the interest income reported by the bondholder each period will equal the interest expense reported by the debtor.

8-23

Purchase at "Other" than Book Value

- Continuing movement in the level of interest rates and the volatility of other factors influencing the securities markets make it unlikely that a company' bonds will sell after issuance at a price identical to their 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 (i.e., a constructive gain or loss) is reported in the consolidated income statement in the period of constructive retirement.

8-24

Purchase at "Other" than Book Value

- The bond interest income and interest expense reported by the two affiliates subsequent to the purchase must be eliminated in preparing consolidated statements.

8-25

Purchase at "Other" than Book Value

- 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.
- The difference in the bond carrying amounts is reflected in the amortization of the discount or premium and, in turn, causes interest income and expense to differ.

8-26

Gain/Loss on Constructive Retirement

- In the preparation of consolidated financial statements, a gain or loss must be recognized for the difference between the book value of the bonds on the date of repurchase and the amount paid by the consolidated entity in reacquiring the bonds.

8-27

Purchase at Greater than Book Value

- When an affiliate's bonds are purchased from a nonaffiliate at an amount greater than their book value, a loss is recognized on the constructive retirement of the debt.
- All other aspects of the consolidation process remain the same, that is, there are no other differences between constructive loss and a constructive gain.

8-28

Types of Leasing Arrangements

- Three types of leasing are discussed in this chapter:
    - Operating Leases.
    - Direct Financing Leases.
    - Sales-Type Leases.
- Consolidation requires full elimination of all leasing transactions between affiliated companies.

8-29

Operating Leases

- The only consolidation eliminations needed in the case of an operating lease between affiliated companies are those to remove the rent expense recorded by the lessee and rental income recorded by the lessor.
- If the affiliates have recorded accrued rent, that also must be eliminated.
- The amount paid by the lessor in acquiring the leased asset and the lessor's depreciation charge represent the proper totals for consolidation.

8-30

Direct Financing Leases

- With a direct financing lease, the lessor usually purchases an asset and enters into a long-term lease that provides the lessee with use of the asset and allows the lessor to earn an acceptable rate of return on its investment.

8-31

Direct Financing Leases

For consolidation purposes, three eliminating entries are needed to remove the financial statement effects of the lease.

Equipment	$330,000	
Leased Equipment		$330,000

Establish owned equipment ($330,000 assumed)

[Continued on next slide.]

8-32

Direct Financing Leases

Capital Lease Obligation	$230,000	
Unearned Interest	$36,000	
Lease Payments Receivable		$266,000

Eliminate intercompany lease obligation.

Interest Income	$33,000	
Interest Expense		$33,000

Eliminate intercompany interest.

Note: All amounts are assumed.

8-33

Direct Financing Leases

- From a consolidated viewpoint, the consolidated entity has purchased and held an asset.
- No adjustment to depreciation expense is needed because the annual depreciation of $110,000 is reflected in the amount taken from the lessor's books and is equal to one-third of the original $330,000 cost of the equipment of the consolidated entity. This is not the case with respect to sales-type leases.

8-34

Sales-Type Leases

- A sales-type lease is one in which the lessor earns some amount of profit from the lease in addition to the interest from financing the transaction.

8-35

Sales-Type Leases

- Assume that the lessor recognizes a $60,000 gain at the inception of the sales-type lease, equal to the difference between the $330,000 present value of the lease payments discounted at 10 percent and the $270,000 ($450,000 - $180,000) book value of the equipment.
- For consolidation purposes, three eliminating entries are needed to remove the financial statement effects of the lease.

8-36

Sales-Type Leases

Equipment	$450,000	
Gain on Sale of Equipment	$60,000	
Leased Equipment		$330,000
Accumulated Depreciation		$160,000
Depreciation Expense		$20,000

Eliminate gain on sales-type lease and establish owned equipment.

Note: All amounts are assumed.

8-37

Sales-Type Leases

• Capital Lease Obligation	$230,000	
Unearned Interest		$36,000
Lease Payments Receivable		$266,000

Eliminate intercompany lease obligation.

• Interest Income	$33,000	
Interest Expense		$33,000

Eliminate intercompany interest.

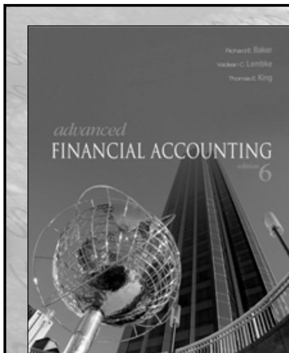
Note: All amounts are assumed.

8-38

You Will Survive This Chapter !!!

- The effects of intercompany debt transactions must be eliminated completely in preparing consolidated financial statements, just as with other types of intercompany transactions.
- Only debt transactions between the consolidated entity and unaffiliated parties are reported in the consolidated statements.

8-39



Chapter 8

End of Chapter

McGraw-Hill/Irwin