Intercompany Inventory Transactions

• Inventory transactions are the most common form of intercorporate exchange.

• Significantly, the consolidation procedures relating to inventory transfers are quite similar to those discussed in Chapter 6 relating to fixed assets.

Intercompany Inventory Transactions

• Conceptually, the elimination of inventory transfers between related companies is no different than for other types of intercompany transactions.

• All revenue and expense items recorded by the participants must be eliminated fully in preparing the consolidated income statement, and all profits and losses recorded on the transfers are deferred until the items are sold to a nonaffiliate.

Transfers at Cost

• Merchandise sometimes is sold to related companies at the seller’s cost or carrying value.

• When an intercorporate sale includes no profit or loss, the balance sheet inventory amounts at the end of the period require no adjustment for consolidation because the carrying amount of the inventory for the purchasing affiliate is the same as the cost to the transferring affiliate and the consolidated entity.

Transfers at Cost

• Even when the intercorporate sale includes no profit or loss, however, 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. This avoids overstating these two accounts.

• Consolidated net income is not affected by the eliminating entry when the transfer is made at cost because both revenue and cost of goods sold are reduced by the same amount.
Transfers at a Profit or Loss

- Companies use many different approaches in setting intercorporate transfer prices.
- In some companies, the sale price to an affiliate is the same as the price to any other customer.
- Some companies routinely mark up inventory transferred to affiliates by a certain percentage of cost.

Transfers at a Profit or Loss

- Regardless of the method used in setting intercorporate transfer prices, the elimination process must remove the effects of such sales from the consolidated statements.
- When intercorporate sales include profits or losses, there are two aspects of the workpaper eliminations needed in the period of transfer to prepare consolidated financial statements (see next two slides).

First Aspect: Income Statement Focus

- Elimination of the income statement effects of the intercorporate sale in the period in which the sale occurs, including the sales revenue from the intercorporate sale and the related cost of goods sold recorded by the transferring affiliate.

Second Aspect: Balance Sheet Focus

- Elimination from the inventory on the balance sheet of any profit or loss on the intercompany sale that has not been confirmed by resale of the inventory to outsiders.

Effect of Inventory System

- Most companies use either a perpetual or periodic inventory control system to keep track of inventory and cost of goods sold.
- Because most companies use perpetual inventory systems, the discussion in the chapter focuses on the consolidation procedures used in connection with perpetual inventories.

Downstream Sale—Perpetual System

- 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.
**Downstream Sale—Perpetual System**

- Consolidated net income must be based on the realized income of the transferring affiliate.
- Because intercompany profits from downstream sales are on the books of the parent, consolidated net income and the overall claim of parent company shareholders must be reduced by the full amount of the unrealized profits.

**1. Profit Realized in Same Period**

- **Required Elimination Entry:**
  
  | Sales       | $10,000 |
  | Cost of Goods Sold | $10,000 |

- Note the elimination entry does not affect consolidated net income because sales and cost of goods sold both are reduced by the same amount. [Continued on next slide.]

**2. Profit Realized in Next Period**

- When inventory is sold to an affiliate a profit and the inventory is not resold during the same period, appropriate adjustments are needed to prepare consolidated financial statements in the period of the intercompany sale and in each subsequent period until the inventory is sold to a nonaffiliate. [Continued on next slide.]

**1. Profit Realized in Same Period**

- No elimination of intercompany profit is needed because all of the intercompany profit has been realized through resale of the inventory to the external party during the current period.

**2. Profit Realized in Next Period**

- By way of illustration, assume that Peerless Products purchases inventory in 20X1 for $7,000 and sells the inventory during the year to Special Foods for $10,000. Thereafter, Special Foods sells the inventory to Nonaffiliated Corporation for $15,000 on January 2, 20X2.
- **Required Elimination Entry (20X1):**
  
  | Sales       | $10,000 |
  | Cost of Goods Sold | $7,000 |
  | Inventory   | $3,000 |
3. Inventory Held Two or More Periods

- Companies may carry the cost of inventory purchased from an affiliate for more than one accounting period. For example, the cost of an item may be in a LIFO inventory layer and would be included as part of the inventory balance until the layer is liquidated.

- 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 from Peerless Products, 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:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained Earnings, January 1</td>
<td>$3,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

Eliminate beginning inventory profit.

Note: No income statement adjustments are needed in the periods following the intercorporate sale until the inventory is resold to parties external to the consolidated entity.

Upstream Sale – Perpetual System

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

Sale from One Subsidiary to Another

- Transfers of inventory often occur between companies that are under common control or ownership.

- When one subsidiary sells merchandise to another subsidiary, 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.
Costs Associated with Transfers

• When inventory is transferred from one affiliate to another, some additional cost, such as freight, is often incurred in the transfer.
• This cost should be treated in the same way as if the affiliates were operating divisions of a single company.
• If the additional cost would be inventoried in transferring the units from one location to another within the same company, that treatment also would be appropriate for consolidation.

Lower of Cost or Market

• Inventory purchased from an affiliate might be written down by the purchasing affiliate under the lower-of-cost-or-market rule if the market value is less than the intercompany transfer price. [Continued on next slide.]

Lower of Cost or Market

• Such a situation can be illustrated by assuming that a parent company purchases inventory for $20,000 and sells it to its subsidiary for $35,000. Also, assume that the subsidiary still holds the inventory at year-end and determines that its market value (replacement cost) is $25,000 at that time. [Continued on next slide.]

Lower of Cost or Market

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:

- Loss on Decline in Value of Inventory $10,000
- Inventory $10,000

Write inventory down to market value.

Lower of Cost or Market

While this entry revalues the inventory to $25,000 on the books of the subsidiary, the appropriate valuation from a consolidated viewpoint is the $20,000 original cost of the inventory to the parent. Therefore, the eliminating entry—shown on the next slide—is needed in the consolidated workpaper.

Lower of Cost or Market

- 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.
Lower of Cost or Market

- The inventory loss recorded by the subsidiary must be eliminated because the $20,000 inventory valuation for consolidation purposes is below the $25,000 market value of the inventory.

Sales and Purchases before Affiliation

- Sometimes companies that have sold inventory to one another later join together in a business combination.

- 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.

Sales and Purchases before Affiliation

- As a general rule, the effects of transactions that are not the result of arm’s length bargaining must be eliminated.

- However, the combining of two companies does not necessarily mean that their prior transactions with one another were not arm’s length.

- The circumstances surrounding the prior transactions, such as the price and quantity of units transferred, would have to be examined.

Sales and Purchases before Affiliation

- 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.

- Thus, if the prior sales were the result of arm’s-length bargaining, they are viewed as transactions between unrelated parties.

- Accordingly, no elimination or adjustment is needed in preparing consolidated statements subsequent to the combination, even if the inventory is still held by an affiliate.

Summary of Key Concepts

- Consolidated financial statements are prepared for the consolidated entity as if it were a single company.

- Therefore, the effects of all transactions between companies within the entity must be eliminated in preparing consolidated financial statements.

Summary of Key Concepts

- For intercompany inventory transactions, the intercompany sale and cost of goods sold must be eliminated.

- In addition, the intercompany profit may not be recognized in consolidation until it is confirmed by resale for the inventory to an external party.

- Unrealized intercompany profits must be eliminated fully and are allocated proportionately against the stockholder groups of the selling affiliate.
Summary of Key Concepts

• If inventory containing unrealized intercompany profits is sold during the period, consolidated cost of goods sold must be adjusted to reflect the actual cost to the consolidated entity of the inventory sold; if the inventory is still held at the end of the period, it must be adjusted to its actual cost to the consolidated entity.

You Will Survive This Chapter!!!

• You can’t make money selling to yourself !!!