Viewpoint

8.2 Intercompany transactions

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The term “intercompany (intra-entity) income” as used in this chapter refers to profit arising from transfer of inventories, properties, or other assets between companies included in consolidated financial statements (including VIEs). Intercompany profit may also arise from the sale of services or other charges (e.g., interest) that are capitalized by the purchasing affiliated company.

The general objective of intercompany income elimination in consolidated financial statements is to exclude from consolidated shareholders’ equity the profit or loss arising from transactions within the consolidated entity and to correspondingly adjust the carrying amount of assets remaining in the consolidated entity. Generally, the gross profit of the selling company is used to adjust the carrying amounts; however, where the selling company would ordinarily capitalize inventoriable costs, it is appropriate for such costs to be capitalized in consolidation by adjustment of the amount of profit eliminated.

ASC 323-10 discusses the equity method of accounting as it applies to corporate joint ventures and investees and states that “intra-entity (intercompany) income shall be eliminated until realized by the investor or investee as if the investee company were consolidated.” However, ASC 323-10-35-9 permits partial elimination of intercompany income on transactions with companies accounted for by the equity method. Refer to EM 4.2 for a discussion of intercompany income elimination under the equity method.

Any profit or loss on a leasing transaction with a related party investee should be accounted for in accordance with the principles set forth in ASC 810-10 or ASC 323-10 as appropriate.

Intercompany income should be eliminated from the applicable asset reflected in the consolidated balance sheet on a before-tax basis. Refer to TX 2.4.4 for a discussion of the tax effects of intercompany transactions.

8.2.1 Accounting for intercompany transactions with VIEs

An entity should consolidate a VIE for which it is the primary beneficiary pursuant to ASC 810-10-25-38 through ASC 810-10-25-38G. After a primary beneficiary initially consolidates a VIE, the basic principles of consolidated financial statements for voting interest entities in ASC 810-10 apply to the primary beneficiary's accounting for the consolidated VIE, with one exception. For a VIE, intercompany income eliminations may not be attributed pro rata between the primary beneficiary and the noncontrolling interests.

ASC 810-10-35-3 explicitly states that (1) any intercompany fees, as well as other sources of income or expenses between a primary beneficiary and a consolidated VIE, should be eliminated against the related expense or income of the variable interest entity and (2) the resulting effect of that elimination on net income or expense of the variable interest entity should be attributed to the primary beneficiary and not to any noncontrolling interest (NCI) in the consolidated financial statements. Therefore, when consolidating a VIE, the elimination of the full intercompany profit should be attributed to the primary beneficiary.

> **ASC 810-10-35-3**
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> The principles of consolidated financial statements in this Topic apply to primary beneficiaries' accounting for consolidated variable interest entities (VIEs). After the initial measurement, the assets, liabilities, and noncontrolling interests of a consolidated VIE shall be accounted for in consolidated financial statements as if the VIE were consolidated based on voting interests. Any specialized accounting requirements applicable to the type of business in which the VIE operates shall be applied as they would be applied to a consolidated subsidiary. The consolidated entity shall follow the requirements for elimination of intra-entity balances and transactions and other matters described in Section 810-10-45 and paragraphs 810-10-50-1 through 50-1B and existing practices for consolidated subsidiaries. Fees or other sources of income or expense between a primary beneficiary and a consolidated VIE shall be eliminated against the related expense or income of the VIE. The resulting effect of that elimination on the net income or expense of the VIE shall be attributed to the primary beneficiary (and not to noncontrolling interests) in the consolidated financial statements.

Accordingly, except as noted above, the consolidation principles described herein should be followed when accounting for consolidated variable interest entities. Within this chapter, the term "parent" includes the "primary beneficiary" as defined in the Master Glossary of the ASC, and the terms "consolidated subsidiary" or "majority-owned subsidiary" include a "consolidated variable interest entity" as defined in the Master Glossary of the ASC for which the primary beneficiary may own some or no equity interest.

8.2.2 Basic principles of intercompany transactions

ASC 810 establishes basic consolidation principles, which include (1) any intercompany income on assets remaining within the consolidated group of companies should be eliminated and (2) the amount of intercompany income to be eliminated is not affected by the existence of an NCI.

> **ASC 810-10-45-1**
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> In the preparation of consolidated financial statements, intra-entity balances and transactions shall be eliminated. This includes intra-entity open account balances, security holdings, sales and purchases, interest, dividends, and so forth. As consolidated financial statements are based on the assumption that they represent the financial position and operating results of a single economic entity, such statements shall not include gain or loss on transactions among the entities in the consolidated group. Accordingly, any intra-entity profit or loss on assets remaining within the consolidated group shall be eliminated; the concept usually applied for this purpose is gross profit or loss (see also paragraph 810-10-45-8).

> **ASC 810-10-45-18**
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> The amount of intra-entity income or loss to be eliminated in accordance with paragraph 810-10-45-1 is not affected by the existence of a noncontrolling interest. The complete elimination of the intra-entity income or loss is consistent with the underlying assumption that consolidated financial statements represent the financial position and operating results of a single economic entity. The elimination of the intra-entity income or loss may be allocated between the parent and noncontrolling interests.

In consolidation, the following are observed practices related to recurring transactions (e.g., inventory) with partially-owned subsidiaries:

> When a sale is made by the parent to a partially-owned subsidiary, the entire elimination of the intercompany gain or loss is generally attributed to the controlling interest.
>
> When the profit arises from the sale by a subsidiary with an NCI to the parent, the entire intercompany profit elimination is either (1) attributed entirely to the controlling interest or (2) attributed proportionately between the controlling and NCI (this method is not allowed for VIEs, as described in CG 8.2.1). Refer to CG 8.2.3 for additional details.

In either case, the amount of profit eliminated from the asset is not affected by the existence of an NCI in the subsidiary. The complete elimination of the intercompany income is consistent with the underlying assumption that consolidated statements represent the financial position and operating results of a single economic entity.

As further discussed in BCG 7.2, sales or transfers of fixed assets and other long-term assets between entities under common control are generally recorded at their carrying amounts at the day of transfer.

8.2.3 Parent sells to partially-owned subsidiary

For transactions in which a parent company or primary beneficiary sells to a partially-owned subsidiary or a consolidated VIE, the elimination of the entire intercompany profit is usually attributed to the controlling interest. In consolidated financial statements, the full attribution of eliminated profits to the controlling interest is appropriate because the intercompany transactions in such cases are not viewed as arm's-length even if expressed in terms of objective market prices. The same guidance should be applied in the parent's consolidated financial statements in situations in which a wholly-owned subsidiary (investee) sells to a partially-owned subsidiary.

The attribution of the full elimination to the controlling interest is demonstrated in Example CG 8-1.

EXAMPLE CG 8-1

Parent sells to partially-owned subsidiary – full intercompany income elimination is attributable to parent

At the beginning of the year, Company A purchases a 60% interest in Company B for $120. At that time, the fair value of Company B's net assets is $200, and the fair value of the NCI is $80. Company B's total capital is $200.

During the year, Company A sells goods to Company B that are in Company B's inventory at year end. The transaction resulted in a profit to Company A as follows:

Selling price	$ 100
Less: cost of sales	(60)
Profit	$ 40

Sales and expense information for Company A and Company B on a separate company basis, before giving effect to intercompany eliminations and NCI income (expense), is as follows:

	Company A	Company B
Sales	$ 1,000	$ 400
Cost of sales	(600)	(260)
Profit	$ 400	$ 140
Selling and administrative	160	40
Net income	$ 240	$ 100

How should Company A account for the intercompany eliminations assuming no allocation is made to the noncontrolling interest?

Analysis

The following journal entries demonstrate the intercompany eliminations when the entire intercompany income eliminated in consolidation is attributed to the controlling interest.

To eliminate Company A's investment in Company B:

Dr. Capital stock in Company B	$ 120	
Cr. Investment in Company B		$ 120

To eliminate intercompany sales and intercompany income in inventory that has not been sold by Company B at year end:

Dr. Sales	$ 100	
Cr. Cost of sales		$ 60
Cr. Inventory		$ 40

To record NCI in Company B:

Dr. Capital stock in Company B ($200 total capital x 40%)	$ 80	
Cr. Noncontrolling interest in Company B		$ 80

Summary of elimination attributed to controlling interest

Consolidated net income prior to elimination of intercompany profit	$ 340
Elimination of intercompany profit in inventory	(40)
Consolidated net income	$ 300
Net income attributable to NCI	40

Net income attributable to Company A	$ 260

The NCI in income of Company B would be calculated as Company B's net income of $100 x 40% NCI in Company B. The result is that the full amount of the intercompany profit elimination would be attributed to the controlling interest.

The following table illustrates the attribution of Company B's net income in consolidation and the entire intercompany elimination to Company:

	Company A	NCI	Total
Share of Company B's net income	$ 60	$ 40	$ 100
Full attribution of intercompany elimination to controlling interest	(40)	—	(40)
Total	$ 20	$ 40	$ 60

Under the full attribution approach, the noncontrolling interest would recognize profit on the sale of inventory to the parent.

Company A would not recognize profit on the intercompany sale of inventory. Company A would recognize its standalone profit of $240, plus its 60% share of the subsidiary's $100 income, less the entire income on the intercompany transaction of $40.

In Year 2, assume Company B sells all of the inventory. Cost of sales would have to be reduced by the prior period's intercompany profit elimination, the effect of which would be attributed entirely to the controlling interest.

For example, in Year 2, assume Company B sells all of the inventory it purchased from Company A during Year 1 for $120. The earnings of Company B would still be allocated 60%/40% to Company A and the NCI, but because Company A would need to also add back the prior period intercompany profit elimination, the amount attributed to the controlling interest would be $52, calculated as follows:

Company B selling price	$ 120
Company B cost of sales	(100)
Company B profit	$ 20
Company A's 60% share of Company B profit	$ 12
Plus: reduction in cost of sales	40
Total income attributable to Company A	$ 52

8.2.4 Partially-owned subsidiary sells to parent

When a partially-owned subsidiary sells to a parent company, there are two acceptable approaches under ASC 810-10-45-18 to attributing the elimination of the intercompany profit or loss. The elimination of intercompany profit or loss may either be fully attributed to the controlling interest, or attributed proportionately between the controlling and noncontrolling interests.

Under the full attribution approach, net income attributable to the parent is charged for the entire intercompany income, including the noncontrolling interest's share. This approach is less complex in application and is based on a view that the parent controls the sale and should eliminate the entire sale in its accounting. However, some believe that the full attribution of the elimination of the intercompany profit made on a sale by a partially-owned subsidiary to its parent understates net income attributable to the parent by the share of intercompany income earned from sale to the NCI.

The attribution of the intercompany income elimination proportionately between the parent and noncontrolling interests reflects the net income earned by the parent for its share of intercompany net income earned to the extent of outside interests. However, it has the disadvantage in consolidated financial statements of understating the equity of the NCI in net assets of the subsidiary by the amount of profit remaining in the parent's assets (i.e., inventory) attributable to the noncontrolling interest of the selling subsidiary. Further, this approach cannot be applied when consolidating a VIE as it is restricted by ASC 810-10-35-3. See CG 8.2.1 for further information.

In situations in which a partially-owned subsidiary sells to a wholly-owned subsidiary, the wholly-owned buying subsidiary should be regarded as the parent entity and the same guidance as discussed above should be applied in the parent's consolidated financial statements. In situations in which a partially-owned subsidiary sells to a partially-owned subsidiary, the entire amount of intercompany profit must be eliminated in arriving at consolidated net income. The amount of the intercompany profit elimination attributed to the NCI should be determined consistently with the approach adopted by the entity for sales to the parent.

A "cost company" is a joint venture formed to serve as a source of supply in which the venturers agree to take production of the investee proportionate to their respective interests. This is substantially a cost-sharing arrangement, and the existence of an outside interest does not increase cost of supplies to the consolidated entity. For this reason, the intercompany income elimination is required to be attributed entirely to the parent.

Example CG 8-2 demonstrates the two different approaches of attributing the elimination of intercompany profit or loss.

EXAMPLE CG 8-2
Partially-owned subsidiary sells to parent – two approaches

At the beginning of the year, Company A purchases a 60% interest in Company B for $120. At that time, the fair value of Company B's net assets is $200, and the fair value of the NCI is $80. Company B's total capital is $200.

During the year, Company B sells goods to Company A that are in Company A's inventory at year end. The transaction resulted in a profit to Company B as follows:

Selling price	$ 100
Less: cost of sales	(60)
Profit	$ 40

Sales and expense information for Company A and Company B on a separate company basis, before giving effect to intercompany eliminations and NCI income (expense), is as follows:

	Company A	Company B
Sales	$ 1,000	$ 400
Cost of sales	(600)	(260)
Profit	$ 400	$ 140
Selling and administrative	160	40
Net income	$ 240	$ 100

How should Company A eliminate the intercompany profit using full attribution to the controlling interest?

Analysis – full attribution approach

The following journal entries demonstrate the intercompany eliminations when the entire intercompany income eliminated in consolidation is attributed to the controlling interest.

To eliminate Company A's investment in Company B:

Dr. Capital stock in Company B	$ 120	
Cr. Investment in Company B		$ 120

To eliminate intercompany sales and intercompany income in inventory that has not been sold by Company A at year end:

Sales	$ 100	
Cost of sales		$ 60
Inventory		$ 40

To record NCI in Company B:

Capital stock in Company B	$ 80	

Noncontrolling interest in Company B		$ 80

Under the full attribution approach, the noncontrolling interest would recognize profit on the sale of inventory to the parent. The attribution of income of Company B to the NCI would be calculated as Company B's net income of $100 x 40% NCI in Company B.

Company A would not recognize profit on the intercompany sale of inventory. Company A would recognize its standalone profit of $240, plus its 60% share of the subsidiary's $100 income ($60), less the entire income on the intercompany transaction of $40.

The following table illustrates the attribution of Company B’s net income in consolidation and the entire intercompany elimination to Company A.

	Company A	NCI	Total
Share of Company B's net income	$ 60	$ 40	$ 100
Full attribution of intercompany elimination to controlling interest	(40)	—	(40)
Total	$ 20	$ 40	$ 60

In Year 2, assume Company A sells all of the inventory. Cost of sales would have to be reduced by the prior period's intercompany profit elimination, the effect of which would be attributed entirely to the controlling interest. The entire $40 profit would be attributed to Company A in Year 2, such that by the end of Year 2, Company A would have recognized its full 60% share of Company B's profit.

How should Company A eliminate the intercompany profit if it is attributed proportionately between the controlling and noncontrolling interest?

Analysis – proportionate attribution approach

The following journal entries demonstrate the intercompany eliminations when the entire intercompany profit eliminated in consolidation is attributed proportionately between the controlling and noncontrolling interests. This method is not permissible for consolidated VIEs.

To eliminate Company A's investment in Company B:

Capital stock in Company B	$ 120	
Investment in Company B		$ 120

To eliminate intercompany sales and intercompany income in inventory which has not been sold by Company A at year end:

Sales	$ 100	
Cost of sales		$ 60
Inventory		$ 40

To record NCI in Company B:

Capital stock in Company B	$ 80	
Noncontrolling interest in Company B		$ 80

Under the proportionate attribution approach, the noncontrolling interest would recognize income of $24, which represents its 40% share of Company B's $100 net income ($40), less its 40% share of the remaining profit in inventory of $40 ($16).

In addition to its standalone profit of $240, Company A would recognize its 60% share of Company B's $100 net income ($60), less its 60% share of the remaining profit in inventory of $40 ($24).

The following table illustrates the proportionate attribution of Company B’s net income and the intercompany elimination in consolidation to Company A and the NCI.

	Company A	NCI	Total
Share of Company B's net income	$ 60	$ 40	$ 100
Proportionate attribution of intercompany elimination	(24)	(16)	(40)
Total	$ 36	$ 24	$ 60

In Year 2, when Company A sells all of the inventory, cost of sales would have to be reduced by the prior period's intercompany profit elimination, and a similar adjustment made to the attribution of income to Company B. In Year 2, 60% of Company B's $40 profit ($24) would be attributed to Company A, such that by the end of Year 2 Company A would have recognized its full 60% share of Company B's profit.

The summary below compares the consolidated net income and adjustments under the two approaches.

	Full attribution to controlling interest	Partial attribution to NCI
Consolidated net income prior to elimination of intercompany profit	$ 340	$ 340
Elimination of intercompany profit	(40)	(40)
Consolidated net income	$ 300	$ 300
Net income attributable to NCI	40	24
Net income attributable to Company A	$ 260	$ 276

8.2.5 Intercompany inventory transactions and the lower of cost or net realizable value test

When intercompany transactions result in a profit, the new basis (cost) of the inventory on the books of the company holding the inventory will include the entire intercompany profit. The intercompany profit and related income taxes are normally eliminated in consolidation.

As part of its normal inventory accounting, as prescribed by ASC 330, *Inventory,* inventory is recorded at the lower of cost or net realizable value (NRV). NRV is defined as the estimated selling price less the cost of completion and sale. If cost exceeds net realizable value, an inventory write-down should be recorded. To the extent that the write-down gives rise to an immediate or a future (upon realization of the inventory loss) tax deduction that, under ASC 740, *Income Taxes*, meets the "more likely than not" criterion, a tax benefit would be recorded as part of the normal calculation of income tax expense. The adjusted amounts should be used for consolidation purposes, which means that the parent and NCI in the company holding the inventory will reflect their respective shares of the recorded inventory write-down net of any tax benefit recorded.

In consolidation, the intercompany income (and related tax effect) that is to be eliminated should be reduced to consider the inventory write-down recorded by the company holding the inventory.

The procedures discussed above are summarized in the following steps:

The company holding the inventory should apply the lower of cost or net realizable value test based on its carrying cost.

If a write-down is required, it should be recorded in the books of the company holding the inventory. The write-down will be reflected in that company's calculation of its income tax provision and thus the tax benefit related to the write-down (to the extent recognizable under ASC 740) will be reflected in the standalone entity financial statements.

The financial statements of the company holding the inventory, as adjusted, should be used in consolidation. As a result, the consolidated financial statements will reflect both the parent's and the NCI's respective shares of that net loss.

From a consolidated point of view, it is generally necessary to adjust the parent's share of intercompany income that would ordinarily be eliminated in consolidation in order to partially or fully offset the parent's share of the write-down recorded by the company holding the inventory. However, if the parent's share of the write-down is greater than the parent's share of the intercompany income elimination, then the adjustment for the parent's share of the intercompany income elimination is not necessary. On the other hand, if the parent's share of the write-down is less than its share of the intercompany income elimination, then the amount of the normal intercompany elimination should be reduced by the parent's share of the write-down.

Whenever the amount of profit eliminated in consolidation is adjusted to take into account an inventory write-down, a corresponding adjustment may need to be made to the income taxes previously paid on the intercompany income (i.e., deferred charge) in consolidation. This is because the amount that continues to be deferred is subject to an after-tax realization test, as discussed in TX 2.4.5.

Example CG 8-3 illustrates the accounting for a write-down of inventory purchased by a partially-owned subsidiary from its parent that was sold at a profit.

EXAMPLE CG 8-3

Parent sells inventory to partially-owned subsidiary – lower of cost or NRV test

At the beginning of the year, Company A purchases a 60% interest in Company B for $120. At that time, the fair value of Company B's net assets is $200, and the fair value of the NCI is $80. Company B's total capital is $200.

Intercompany profits are eliminated in their entirety and fully attributed to the parent (Company A) as described in Example CG 8-1.

During the year, Company A sells goods to Company B that are in Company B's inventory at year end. There were no other intercompany transactions during the year. The intercompany sale of inventory resulted in a profit to Company A and a related tax expense on a standalone basis as follows:

Selling price	$ 100
Less: cost of sales	(60)
Profit before tax	$40

At the end of the year, the goods acquired from Company A by Company B have an NRV of $70. As shown below, Company B writes down the inventory to net realizable value, with the $30 adjustment to cost of sales reflected in Company B's income statement. In computing its current provision for income taxes, the $30 write-down is fully deductible.

	Company B	NRV write-down	Company B after write-down
Inventory	$ 100	$ (30)	$ 70
Sales	—	—	—
COGS	—	(30)	(30)
Pretax (loss)	—	$ (30)	$ (30)

Analysis

The following journal entries demonstrate the intercompany eliminations that should be recorded in consolidation, as well as the impact to Company A's accounts of the inventory write-down that was recorded by Company B. For ease of illustration, tax effects have been ignored.

To eliminate intercompany sales and intercompany income in inventory before giving effect to the inventory write-down recorded by Company B:

Sales	$ 100	
Cost of sales		$ 60
Inventory		$ 40

Consistent with Example CG 8-1 and Example CG 8-2, this adjustment is necessary as the sellers' pre-tax profit is deferred in consolidation, and the asset is carried at its cost to the seller until it is sold to an unrelated third party.

To reverse the write-down of inventory recorded by Company B by recognizing intercompany profit to the extent of the write-down of $30:

Dr. Inventory	$ 30	
Cr. Cost of sales		$ 30

This adjustment is necessary as the inventory balance in consolidation has already been adjusted to reflect the seller's cost basis of $60, which is below the $70 NRV for the inventory.

To defer profit equal to the NCI's share of the write-down (40% of $30), which would otherwise be recognized in Company A's income:

Dr. Cost of sales	$ 12	
Cr. Deferred income liability		$ 12

This adjustment in effect recognizes the NCI's share of Company B's write-down in Company A's consolidated financial statements, and defers Company A's 60% share of the write-down ($18), which would be recognized when Company B sells the inventory to a third party. Because Company B wrote down the inventory by $30, and Company A's share of that write-down is $18, Company A would recognize $22 ($40 - $18) of profit if Company B were to sell its inventory to a third party.

A summary of the adjustments and resulting balances are shown below.

	Co A	Co B	Total	Adj 1	Adj 2	Total after Adj	Adj for NCI	Total Consol
Inventory	—	$70	$70	$(40)	$30	$60	—	$60
Deferred income liability	—	—	—	—	—	—	12	12
Sales	$100	—	$100	$(100)	—	—		—
COGS	(60)	(30)	(90)	60	30	—	(12)	(12)
Pretax profit	$40	$(30)	$10	$(40)	$30	—	(12)	$(12)*

*The pre-tax loss of $12 represents the amount attributable to NCI that must be charged to adjust the parent's share of the write-down. In Year 2, assume Company B sells all of the inventory at $70, cost of sales would have to be reduced by the prior period's intercompany loss elimination, the effect of which would be attributed entirely to the controlling interest which would result in recognition of intercompany profit of $22.

8.2.5.1 Intercompany transactions at a loss

Both ASC 810-10-45-1 and ASC 323-10-35-7 provide for elimination of intercompany losses (by increasing the carrying amount of the related assets) in a manner consistent with intercompany income. When accounting for intercompany inventory sales at a loss, a similar procedure as described in CG 8.2.4 should be followed, but special care must be exercised in making a lower of cost or net realizable value test of the inventories of the purchasing company. NRV must cover both the carrying amount reflected in the inventories as recorded in the books of the company holding the inventories, the related tax effects on the intercompany transactions (see TX 2.4.4), and the losses deferred (added to carrying amount) by consolidating entries. If NRV is exceeded after deferring the losses in the consolidating entries, the losses that would otherwise be deferred in consolidation should be reduced, and a corresponding adjustment made to the related tax effect, to reflect the NRV test determined at the consolidated level.

Intercompany losses should not be eliminated (deferred) if they represent a permanent loss of value of assets that should have been adjusted through lower of cost or net realizable value or other impairment models even if the assets had not been transferred to an affiliated company.

8.2.6 Intercompany income on sales to regulated affiliates

ASC 980-810-45-1 through ASC 980-810-45-2 provides that intercompany income arising from a sale by a nonregulated parent or affiliate to a regulated affiliate should not be eliminated if the sales price is reasonable and it is probable that, through the rate-making process, future revenue will approximate the sales price that will result from the regulated affiliate's use of the products. The sales price usually would be considered reasonable if it is accepted or not challenged by the regulator that governs the regulated affiliate. See UP 17.7 for guidance on intercompany transactions with a regulated entity.