ACC 401: Module 4 Lecture Notes
Title: Intercompany Profit Transactions - Inventories

Under the current revenue recognition principle, firms recognize revenue when it is realized; that is, when it is earned. For revenue to be earned from the viewpoint of the consolidated entity, there must be a sale to outside entities. Revenues on sales between affiliates cannot be recognized until merchandise is sold outside of the consolidated entity.

No consolidated income results from transfers among affiliates. The sale of inventory items by one company to an affiliate produces reciprocal sales, purchase amounts when the purchaser has a periodic inventory system, and reciprocal sales and cost of goods sold accounts when the purchaser uses a perpetual inventory system.

Reciprocal sales and cost of goods sold or purchase amounts are eliminated in preparing a consolidated income statement in order to report sales and cost of goods sold for the consolidated entity; eliminating the sales and cost of goods sold has no effect on consolidated income.

The consolidated entity realizes and recognizes the full amount of intercompany profit on sales between affiliates in the period in which the merchandise is resold to outside entities. Until reselling the merchandise, any profit or loss on intercompany sales is unrealized and must be eliminated during the consolidated process.

The ending inventory of the purchasing affiliate reflects any unrealized profit of loss on intercompany transfer price rather than cost to the consolidated entity. The elimination is a debit to cost of goods sold and a credit to the ending inventory for the amount of unrealized profit. The credit reduces the inventory to its cost basis to the consolidated entity; and the debit to cost of goods sold increases cost of goods sold to its cost basis.

The first entry eliminates intercompany sales and cost of sales. The second entry defers any intercompany profit that remains unrealized and reduces the ending inventory to its cost to the consolidated entity. The debit to cost of sales reduces profit by increasing consolidated cost of sales, and the credit reduces the valuation of inventory for consolidated statement purposes from the intercompany transfer price to cost.

Unrealized profit in an ending inventory is realized for consolidated statement purposes when the merchandise is sold outside the consolidated entity. Ordinarily, realization occurs in the immediately succeeding fiscal period, so firms simply defer recognition for consolidated statement purposes until the following year.

Recognition of the previously unrealized profit requires a workpaper credit to cost of goods sold, because the amount of the beginning inventory is reflected in cost of goods sold when the perpetual system is used.

The journal entry to record the previously deferred profit is a debit to investment in subsidiary to adjust for the one-line consolidation entry that reduced the Investment in Subsidiary account in the previous year. The credit reduces to the cost of goods sold account and serves to increase consolidated profit.

A downstream sale is a sale by a parent to a subsidiary. A sale by a subsidiary to a parent is an upstream sale. The upstream and downstream designations relate to the usual diagram of
affiliation structures that places the parent at the top. Therefore, sales from top to bottom are
downstream, and sales from bottom to top are upstream.

Consolidated statements eliminate reciprocal sales and cost of goods sold amounts for both
upstream and downstream sales. Unrealized gross profit in ending inventory is also eliminated
in its entirety for both downstream and upstream sales.

However, the effect of unrealized profits in ending inventory on separate parent statements and
on consolidated financial statements is determined by both the direction of the intercompany
sales activity and the percentage ownership of the subsidiary, except for 100 percent-owned
subsidiaries that have no noncontrolling ownership.

In the case of downstream sales, the parent’s separate income includes the full amount of
unrealized profit, and the subsidiary’s income is unaffected. When sales are upstream, the
subsidiary’s net income includes the full amount of any unrealized profit, and the parent’s
separate income is unaffected.

The consolidation process eliminates the full amount of intercompany sales and cost of sales for
both downstream and upstream sales. However, noncontrolling interest share may be affected if
the parent’s separate income includes unrealized profit – the upstream situation. It is not
affected if the parent’s separate income includes unrealized profit, the downstream situation,
because the noncontrolling shareholders have an interest only in the income of the subsidiary.