

Recognizing a Parent and Subsidiary Gain or Loss in Indirect Intercompany Bond Transactions

Paul J. Lee* Rahmat Tavallali Stephanie Lee

Abstract

Through this research, we will investigate 1) indirect inter-company debt transactions between a parent company and its subsidiary, 2) the proper way to reflect these transactions in consolidated financial statements, and 3) four different ways of allocating a gain or loss from a retired debt resulting from indirect inter-company transactions. In particular, a bond will be used as an example for debt transactions throughout. Through this research, we will look for logical ways to account for these issues in the hope of providing accurate information to generate more objective and meaningful consolidated financial statements.

Keywords: indirect inter-company, debt transactions, parent company, subsidiary, consolidated financial statements, allocation, retired debt, bond, accounting.

I. Introduction

FASB Codification 810 Consolidation provides guidelines for the preparation and presentation of consolidated financial statements with respect to scope, measurement, and consolidation procedure. However, even though GAAP is rules-based and attempts to provide rules for every situation, there will always be limitations in setting consolidation rules because of all of the possible various and broad business situations. One of the examples of these is how to allocate the gain or loss of a retired debt—specifically, a bond between a parent and its subsidiary resulting from indirect intercompany debt transactions. This is an important question because the net income of a parent, a subsidiary, a consolidated controlling interest, and a non-controlling interest will all change according to the type of the gain- or loss-bearing entity. Therefore, through this research, we will investigate 1) indirect intercompany debt transactions between a parent company and its subsidiary, 2) the proper way to reflect these transactions in consolidated financial statements, and 3) four different ways of allocating a gain or loss from a retired debt resulting from indirect intercompany transactions. In particular, a bond will be used as an example for debt transactions in this research. Through this research, we will look for logical ways to account for these issues in the hope of providing accurate information to generate more objective and meaningful consolidated financial statements.

II. Indirect Intercompany Bonds Transactions

If a subsidiary company issues bonds and a parent later buys the bonds (or vice versa), this is referred to as a direct intercompany debt transaction, similar to direct transactions of land, inventory and equipment between any parent and its subsidiary. However, if a third party is involved in this debt transaction, where either the parent or subsidiary has issued a bond to the third party and later the non-issuing parent or subsidiary has bought the bond from the third party, these transactions are called indirect intercompany debt transactions. Figure 1 below shows a typical indirect intercompany bond transaction:

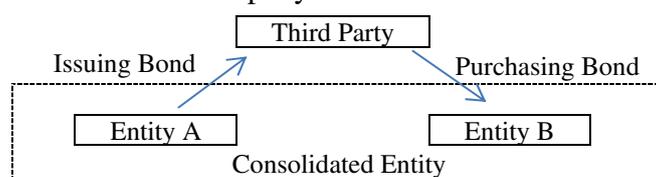


Figure 1. Indirect Intercompany Bond Transaction

Direct debt transactions and any gain or loss between parent and subsidiary must be eliminated when looking from the consolidation point of view. How should indirect debt intercompany transactions be reflected in the consolidated financial statements? Due to the bond seller and the buyer being the same entity from the consolidated entity's perspective, the transactions must be treated as intercompany transactions even when a third party is involved. In the consolidated financial statements, because the consolidated entity bought back their own bond through the parent or parent's subsidiary, the bond must be retired on the day of purchase and is considered constructively retired and referred to as an early retired or constructive bond (Chaney & Jeter, 2001).

III. Consolidation Process of Constructive Bond

In indirect intercompany bond transactions, because bond prices always fluctuate according to economic conditions, interest rates, and many other market factors, the book value of an issuer's bond and the bond purchase price wouldn't be the same in most cases. For example, because of low interest rates, a subsidiary company (S) issues bonds at a discount but the market interest rate decreases later, causing the interest on the bonds to become relatively higher than that of other bonds of the market. In this case, S might want to retire the bond and issue another bond with a lower interest rate. However, the higher-interest bond that S sold to an outside party is attractive for its parent company (P) to buy, so P buys the bond from the outside party at a premium. The book value of S's bond (Bond Payable – Discount on Bond) will be lower than par value; on the other hand, P's investment in S will be higher than the bond's par value. Because of this, there will be many various bond issue-price and purchasing-price combinations such as selling at par and buying at a discount, selling bonds at a premium and buying the bonds at par, and many others.

From the consolidated viewpoint, if the bond purchase price is higher than the issuer's book value, the loss should be recognized. If the purchase price is lower than the bond book value, the gain should be recognized also. These gains and losses resulting from constructive bonds are called constructive gains and losses (Chaney & Jeter, 2001), and are calculated from the difference between the book value of the bond liability (carrying value) and the purchase price of the bond. Constructive gains and losses are treated in a different way from other gains and losses from other assets, such as inventory or equipment direct intercompany transactions where the gain or loss is currently recorded on the books of the selling company but deferred (eliminated) by consolidation worksheet entries until the assets are sold to an outside party. The constructive gain or loss must be recognized in consolidated financial statements in indirect transactions because cash is paid to the outside party but not to either parent or subsidiary. Thus, even if the constructive gain or loss must be recognized for consolidation purposes and the bond must be retired, the subsidiary and parent companies continue to record the Bond Liability and Investment in S accounts respectively in their books over the life of the bond; therefore, any gain or loss is not recorded in their books prior to consolidation worksheet entries. These constructive gains and losses are recorded via worksheet entries at first in the period when the bond is purchased. After the bond purchasing period, the gain or loss which was recorded in the individual subsidiary and parent company's accounts are eliminated by worksheet entries. Therefore, indirect intercompany bond worksheet entries are conducted in an inverse way compared to direct intercompany transactions when the bond is retired.

Which party should bear the constructive gain or loss? Should all of the gain or loss be the sole responsibility of the parent company or the subsidiary? Should both companies bear the gain or loss equally? From the consolidation point of view, determining the gain or loss

bearing entity is not important because Consolidation Net Income is the sum of both parent and subsidiary net income, which will be the same regardless of who is the gain or loss bearing entity. What happens when a subsidiary has a Non-Controlling Interest? If the subsidiary bears the loss, the subsidiary's income should be adjusted (decreased) as much as the loss, and accordingly, the parent's controlling interest and NCI should be adjusted (decreased) as much as each parent and NCI's percentage interest in subsidiary's loss as well. However, if the parent bears the loss, it would affect the parent's income along with the controlling income but not affect the subsidiary's income or NCI in the consolidated income statement thereafter. If the subsidiary managers' compensation bonuses are related to the company's net come or if they have targeted a certain Net Income, the decision of who will bear the gain or loss will be more sensitive to them. We will investigate how to allocate the constructive gain or loss in detail in the following section.

IV. Allocation of Constructive Gain or Loss

Absent from FASB guidelines or agreement is the matter of how the constructive gain or loss should be allocated between a parent and subsidiary; however, there are four methods that are used in accounting practice. The four methods were mentioned and recommended in the FASB's Discussion Memorandum, paragraph 384, which is an analysis of issues related to Consolidation Policy and Procedures (Pacter, 1991). These four methods are as follows:

- 1) Issuing Company bears all the gain or loss
- 2) Purchasing Company bears all the gain or loss
- 3) Parent Company bears all the gain or loss
- 4) Both Issuing and Purchasing Companies bear all the gain or loss

We will investigate the four methods and the rationale behind each method one by one and how it affects consolidated income, Parent and Subsidiary company's income, and NCI. In addition, we explain how managers might use these methods for management purposes. To help understand concepts and compare an issuing and purchasing company's net income and NCI, we will use the following simple example:

Example

P company has a 90% interest in S company. On 01/01/20x4, S issued bonds at a discount on the market, and at the end of the year, P bought all the bonds from third parties at \$104,000 (at a premium). At the time, S's bond liability book value was \$98,000. S and P's internal net incomes are \$30,000 and \$140,000, respectively. We assume that there are no other intra-transactions between P and S companies.

In this example, because P Company paid more than the book value of S's bonds, when P bought the bonds, a constructive loss of \$6,000 ($\$104,000 - \$98,000$) should be recognized in the consolidated financial statements. Therefore, total Consolidated Net Income will be \$164,000 ($\$164,000 = P's\ NI\ of\ \$140,000 + S's\ NI\ of\ \$30,000 - \text{constructive loss of } \$6,000$).

Method 1: Gain or Loss Allocated Entirely to the Issuing Company

The first method is that the bond-issuing company should bear all the constructive gain or loss. It does not matter whether intercompany transactions are up-stream or down-stream, but the bond-issuing company solely bears all the gain or loss. Thus, this method emphasizes the debtor's position in the constructive bond transactions.

The rationale for this method is that, because the bond-issuing company has the obligation to pay back the bond liability, when the bonds are extinguished, any resulting gain or loss

relates to the issuing company (Doupnik, Hoyle & Schaefer, 2001). For its part, the bond-purchasing company still has a right to receive interest income from the issuing company even though the bond is retired from a consolidated viewpoint.

This method is also explained through “Agent theory.” All of the responsibility resulting from Agent behavior is on the principal, which is the bond issuer, since the purchasing company is merely one of the affiliated companies with the issuer and serves as a purchasing agent for the original bond issuer. The issuer must bear the entire bond retirement gain or loss when the Agent company bought the bonds (Cheng, Fischer & Taylor, 2011). Fair value accounting also supports this treatment. Generally a bond-issuing company would recognize any change in the market value of its bond in its statement of profit or loss and other comprehensive income (OCI), and the purchasing company would record the price of the bond at market value; therefore, no further gain or loss would be recognized in the consolidation adjustment (Tong 2000) This method was recommended by the FASB Exposure Draft, “Consolidated Financial Statements: Policy and Procedures in 1995” (Doupnik, Hoyle & Schaefer, 2001).

When S is the issuer and the first method is applied, S’s net income and NCI will fluctuate depending on the gain or loss resulting from returning the bonds, respectively, but P’s income and Consolidated Net Income will not be affected. P’s internal net income will fluctuate if P issues the bonds, but S’s net income and NCI will not be affected. In the previous example, because the bond-issuing company S bears all of the \$6,000 loss, S’s net income decreased to \$24,000 (30,000 – 6,000); accordingly, NCI was reduced by 10% of \$6,000 as well, so NCI fell to \$2,400 (\$3,000 – \$600). However, consolidated net income is the same as \$164,000. Table 1 below shows the calculation:

Table 1. Method 1: Consolidated Net Income

Company S Income Distribution		Company P Income Distribution	
Internally Generated NI	\$30,000	Internally Generated NI	\$ 140,000
Adjustment:		S’s Realized Net Income	<u>24,000</u>
<u>Loss on Bond Retirement</u>	<u>(6,000)</u>	Consolidated Net Income	<u>164,000</u>
Net Income	<u>24,000</u>	Income to NCI	2,400
NIC (10%)	<u>\$2,400</u>	Income to Controlling Interest	<u>\$161,600</u>

Method 2: Gain or Loss Allocated Entirely to the Purchasing Company

Other accountants argue that instead of the bond-issuing company, the bond-purchasing company should bear all of the constructive gain or loss resulting from indirect intercompany retired bonds regardless of whether the purchasing company is the parent or subsidiary. The supporting rationale for this method is that the constructive bond transactions are initiated by the purchasing company, and the income effect resulting from the retired bonds is created by the purchasing company as well. Also, the purchasing company is more actively involved in bond price negotiations, which determine the gain or loss. Consequently, for all of these reasons, the bond-purchasing company should bear all of the constructive gain or loss.

In our example, P bought the bonds and, therefore, P should bear all of the \$6,000 loss. As a result, P’s internal net income is decreased by \$6,000, but S’s net income and NCI are unaffected, and the consolidated net income of \$164,000 will not be affected either. The calculation of consolidated net income is shown in Table 2:

Table 2. Method 2: Consolidated Net Income

Company S Income Distribution		Company P Income Distribution	
Internally Generated NI	\$30,000	Internally Generated NI	\$ 140,000
		Adjustment:	
		<u>Loss on Bond Retirement</u>	(6,000)
		S's Realized Net Income	<u>30,000</u>
		Consolidated Net Income	<u>164,000</u>
		Income to NCI	3,000
NCI (10%)	<u>\$3,000</u>	Income to Controlling Interest	\$161,000

Then, who would buy bonds if they had to bear a loss? Even though Consolidated Net Income is unaffected, S's managers and S's Non-Controlling Interest shareholders would be unhappy if P used its influence to force S to buy loss-bearing bonds and would try to make S resist the decision. On the other hand, if the bonds produced a constructive gain, S would probably voluntarily buy the bonds to recognize a gain from the retired bonds and record higher internal net income and NCI. Thus, according to whether buying the constructive bond is harmful or beneficial, there can be a conflict of interest between P and S when P controls S's financial decision.

Method 3: Gain or Loss Allocated Entirely to the Parent Company

The third method is always allocating all of the constructive gain or loss to the Parent company, and the matter of whether the Parent is the issuer or buyer is no longer relevant. The rationale for this method is that, because consolidated affiliates' financing decisions are maintained and controlled by the Parent company, P has the ultimate power to make the bond repurchase decision (Doupnik, Hoyle & Schaefer, 2013). Therefore, P should bear the gain or loss resulting from its decision-making power. In this method, S's net income and NCI will be unaffected regardless of whether the bonds transactions fluctuate since P bears all of the gain or loss. There would be no conflict of interest between Parent and Subsidiary. If we apply the third method to the example, the result will be the same as that of the second method because the Parent bears the loss in both methods. Table 3 below shows the calculation:

Table 3. Method 3: Consolidated Net Income

Company S Income Distribution		Company P Income Distribution	
Internally Generated NI	\$30,000	Internally Generated NI	\$ 140,000
		Adjustment:	
		<u>Loss on Bond Retirement</u>	(6,000)
		S's Realized Net Income	<u>30,000</u>
		Consolidated Net Income	<u>164,000</u>
		Income to NCI	3,000
NCI (10%)	<u>\$3,000</u>	Income to Controlling Interest	\$161,000

Method 4: Gain or Loss Allocated Between the Issuing and Purchasing Companies: Par Value Theory

In the fourth method, both the bond-issuing company and bond-purchasing company bear the constructive gain or loss but not equally if the bond was not issued or purchased at par value.

Known as the Par Value Theory, both the companies bear a gain or loss only to the extent of the difference between the issuer's bond book value (or the buyer's bond purchase price) and the bond par value (Chaney & Jeter, 2001). The total constructive gain or loss will be the same as that from netting one company's gain or loss against the other company's gain or loss. For instance, in our example, when P bought the bonds, S's bond book value was \$98,000, which is \$2,000 less than the bond's par value of \$100,000; consequently, S should

recognize a \$2,000 loss. P purchased the bond at \$104,000 at a \$4,000 premium, so they paid \$4,000 more than the par value of \$100,000, so P should recognize a \$4,000 loss. And if we add S and P's losses together, it will be the same as the total loss of \$6,000 (S's loss \$2,000 + P's loss \$4,000). Refer to the description below:

When P bought the \$100,000 par value bond for \$104,000 on 12/31/20X4, S's book value for the bond was \$98,000.

S's Bond Book Value \$98,000	Par Value \$100,000	Purchase Cost \$104,000
\$2,000 Loss Allocated to S	\$4,000 Loss Allocated to P	
<div style="display: flex; justify-content: space-between; align-items: center;"> ← Total Loss \$6,000 → </div>		

There are three other cases where both P and S would bear a constructive gain or loss:

Case 1 -- Both bond book value and purchase price are higher than par value:

P bought the bond at \$115,000 at a premium and, at that time, S's book value for the bond was \$110,000. The total constructive loss is \$5,000 (book value of \$110,000 – purchasing price of \$115,000), and S recognizes a \$10,000 gain (book value of \$110,000 – par value of \$100,000) and P recognizes a \$15,000 loss. If we net the two numbers, we get an overall \$5,000 loss (a gain of \$10,000 + a loss of \$15,000), which is the same as the total constructive loss. Even though there is a constructive loss in the consolidated financial statements, either parent or subsidiary company could recognize the gain or loss to increase their internally generated net income.

Case 2 -- Both bond book value and purchase price are lower than par value:

P bought the bond at \$95,000 at a discount and, at that time, S's book value was \$85,000. In this case, a \$10,000 loss (\$85,000 – \$95,000) must be recognized in the consolidated financial statements because P paid \$10,000 more than the bond's book value. But S recognizes a \$15,000 loss (\$15,000 less than par value) and P recognizes a \$5,000 gain (paid \$5,000 less than bond par value). So again, even though the loss should be recognized for consolidation, either P or S could receive the gain as a result of consolidation.

Case 3 -- When purchase price is lower than par value, the bond book value is higher than par value:

P bought the bond at \$85,000 at a discount and, at that time, S's book value was \$110,000. A gain of \$25,000 (\$110,000 – \$85,000) must be recognized, and P bears a \$15,000 gain (\$100,000 – \$85,000) and S bears a \$10,000 gain (\$110,000 – \$100,000).

As we examined the above cases of how S and P may bear a constructive gain or loss when we apply the fourth method, each of P's and S's net incomes are affected not by their affiliated entity's selling and buying of the bond, but by their own current bond book value. This is consistent with other types of intercompany direct transactions that allocate gain or loss between parent and subsidiary, so some accountants suggest that this method is conceptually the soundest (Chaney & Jeter, 2001), and assigning the constructive gain or loss to only one company is misleading (Douppnik, Hoyle & Schaefer, 2001).

In our example, because P and S bear losses of \$2,000 and \$4,000 respectively, P's and S's net incomes are reduced by the same amount, and NCI is also reduced by as much as 10% of the loss born by S, which is \$400 (10% * \$ 4,000). The total Consolidated Net Income is the same as \$164,000. The calculation is as follows:

Table 4. Method 4: Consolidated Net Income

< Company S Income Distribution>		< Company P Income Distribution>	
Internally Generated NI	\$30,000	Internally Generated NI	\$ 140,000
Adjustment:		Adjustment:	
<u>Loss on Bond Retirement</u>	<u>(2,000)</u>	<u>Loss on Bond Retirement</u>	(4,000)
Net Income	<u>28,000</u>	S's Realized Net Income	<u>28,000</u>
		Consolidated Net Income	<u>164,000</u>
		Income to NCI	2,800
NCI (10%)	\$2,800	Income to Controlling Interest	\$164,000

So far, we have investigated the four methods for assigning a constructive gain or loss between a parent company (P) and its subsidiary company (S) and how each method affects P's and S's net incomes and NCI in consolidated financial statements. Because Consolidated Net Income is the sum of P's and S's net incomes, it is not affected by the four methods and the result was always the same at \$164,000 regardless of the method; however, because NCI has an interest in S, if S bears a gain or loss resulting from the retirement of bonds, S's net income and NCI are affected by the different methods, and increased or decreased depending on whether a gain or loss is born; therefore, P's controlling interest and NCI will vary depending on the method. Since controlling and non-controlling interests are affected according to whether P or S is the gain- or loss-bearing entity, each company's managers and shareholders might have conflicts of interest when gains and losses are allocated. Agreements between parent and subsidiary companies or company policies on how to allocate constructive gain or loss are necessary. And the method should most accurately and fairly represent the company's financial condition in the consolidated financial statements.

V. Conclusion

When a parent buys a bond from an outside party and the bond was originally issued by the parent's subsidiary (or vice versa), from the point of view of consolidation, the bond should be retired and any gains or losses must be recognized in the consolidated financial statements. In accounting practice, there are four different ways that the gains and losses resulting from retired bonds could be recognized; the gains and losses could be recognized 1) by the debt-issuing company, 2) by the debt-purchasing company, 3) by the parent company, and 4) by both the debt-issuing company and the debt-purchasing company. These assignments do not affect consolidated net income but change the proportion of controlling and non-controlling interest (NCI). Because gain or loss allocation methods affect S's net income and NIC, prior agreement among affiliated companies about the method to be used is needed to prevent any conflicts of interest. Moreover, the methods can be abused for earnings management because the parent's and subsidiary's net incomes could be increased or decreased as a result of bearing a constructive gain or loss, through managers' arbitrary decision on which allocation method to use. This could give a misleading impression of a parent's or subsidiary's financial situation, and if each company used a different method, it would ruin comparative financial information and analysis among companies. Therefore, to provide comparative and

consistent financial information to investors, authoritative guidelines or agreement among accountants on how to allocate constructive gains and losses is necessary.

Business mergers and investing in other companies are common practices in the business worlds; consequently, more and more companies are required to prepare consolidated financial statements. Therefore, discussion and research among accounting practitioners and accounting rules and regulations authorities are needed to establish standard guidelines for the assignment of constructive gains and losses in consolidated financial statements. Thus, the financial statements will provide accurate, comparable information to investors about companies' financial condition.

References

- Baker, R., Christensen, T., & Cottrell, D. (2011). *Advanced Financial Accounting*. New York, NY: McGraw-Hill Companies, Inc.
- Beams, F. A., Brozovsky, J. A. & Shoulders, C. D. (2000). *Advanced Financial Accounting (7th Ed.)*. Upper Saddle River, New Jersey: Prentice-Hall, Inc.
- Chaney, P. K., & Jeter, D. C. (2001). *Advanced Accounting (5th Ed.)*. Danvers, MA: John Wiley & Son, Inc.
- Cheng, R. H., Fisher, P. M. & Taylor, W. J. (2011). *Advanced Financial Accounting (11th Ed.)*. Ch5. Mason, OH: South-Western Cengage Learning.
- Doupnik, T. S., Hoyle, J. B. & Schaefer, T. F. (2001). *Advanced Financial Accounting (6th Ed.)*. New York, NY: McGraw-Hill Companies, Inc.
- Doupnik, T. S., Hoyle, J. B. & Schaefer, T. F. (2013). *Advanced Financial Accounting (11th Ed.)*. New York, NY: McGraw-Hill Companies, Inc.
- FASB Accounting Standard Codification (n.d.). *810-10-15 Consolidation - Overall – Scope*, Retrieved November 18, 2014 from <https://asc.fasb.org/link&sourceid=SL5899822-111674&objid=58129827>
- Pacter, P. (1991). *An Analysis of Issues Related to Consolidation Policy and Procedures*. New York, NY: Financial Accounting Standards Board.
- Tong, T. L. (2013). *Advanced Financial Accounting (International Ed.)* : CCH Asia Limited
- Wiecek, I. M & Young, N. M. (2010). *IFRS Primer International GAAP Basics (U.S. Ed.)*: Danvers, MA: John Wiley & Sons, Inc.

Authors

Paul J. Lee*, Ph.D., CPA

Associate Professor, Cleveland State University, p.j.lee@csuohio.edu

Rahmat Tavallali, Ed. D

Professor, Walsh University

Stephanie Lee, MBA,

Cleveland State University

*corresponding author