Journal of Accountancy

Volume 35 | Issue 5 Article 4

5-1923

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By W. T. Sunley

Probably the most fascinating of all accounting problems are those dealing with consolidated statements and the intricate relationships which they may present; and one of the most interesting of these complications arises when one of the related companies has on hand at the date of the balance-sheets merchandise which another of the related companies has sold to it at a profit.

The writer offers the proposition that the treatment of such unrealized inter-company profit in respect to minority holdings depends upon whether the minority interests are in the company selling the merchandise or the company buying the merchandise; and it is the purpose of this article to offer reasons in support of that proposition.

At the very beginning the whole basis of the proposition will meet opposition from those accountants who contend that the total inter-company profits included in the inventories of the affiliated companies should be eliminated or reserves created for them by a reduction of the majority interest in the surplus regardless of any minority interest in those profits. So let us give this matter first consideration.

It has been offered by able accountants that the purpose of the consolidated balance-sheet, except when prepared for tax purposes, is to present the interest of the holding company's stockholders and the interest of the minority stockholders in the values owned by the combined interests; and that the minority stockholders are outsiders as far as any related company is concerned and so are entitled to their share of any profit made on a sale to such related company. This argument may or may not be acceptable; but let us view the matter from this angle: If we do not accept this argument, what other courses are open and how logical are the effects? It will perhaps be somewhat easier to follow if we assume a statement of facts and see what may be done with the figures.

The Auto Company owns 80 per cent. of the capital stock of the Wheel Company. On December 31, 1922, their balance-sheets were as follows (these balance-sheets are condensed to show only the necessary details):

WHEEL COMPANY

Assets

Net assets	$150,000

Liabilities and net worth

Capital stock	$100,000
Surplus	50,000
Total	$150,000

AUTO COMPANY

Assets

Sundry assets	$532,000
Inventory of wheels	110,000
Investment in Wheel Co.	120,000
Total	$762,000

Liabilities and net worth

Liabilities	$ 62,000
Capital stock	500,000
Surplus	200,000
Total	$762,000

The inventory of wheels shown on the balance-sheet of the Auto Company represents wheels sold to it by the Wheel Company at 10 per cent. profit.

These balance-sheets present no difficulty whatever. We may, apparently, elect to adopt either of the advocated methods without justifying sensible criticism. If we agree with those who advocate the reduction of the majority's surplus by the amount of the total inter-company profits represented in the Auto Company's inventory, the majority's surplus will be calculated as follows:

Surplus of Auto Company	$200,000
Share of surplus of Wheel Company 80% of $50,000	40,000
	$240,000
Deduct—Unrealized inter-company profits	10,000
Majority's surplus	$230,000

And the minority's surplus will be, of course, 20 per cent. of the surplus of the Wheel Company, or $10,000.

If we agree with those who advocate the reduction of the majority's surplus by the amount of the majority's interest in the inter-company profits represented in the Auto Company's inventory, the majority's surplus will be increased. The calculation follows:

Surplus of Auto Company	$200,000
Share of surplus of Wheel Company, 80% of $50,000	40,000
	$240,000
Deduct—Majority's share of unrealized inter-company's profits	8,000
Majority's surplus	$232,000

Between the results obtained by the two methods there is a monetary difference of two thousand dollars, but this example does not seem to furnish much basis for establishing the real difference between the one and the other. This, perhaps, is one of the reasons why the difference is not readily seen; the average example obscures rather than reveals the fundamental difference. But let us shear the Wheel Company of all profits except the unrealized inter-company profit represented in the inventory of the Auto Company. Then the real effects of the methods will stand out clearly, unobscured by the other profits which hid them from view in our first example.

Balance-sheets at December 31, 1922, were as follows:

WHEEL COMPANY

Net assets	$110,000
Capital stock	$100,000
Surplus	10,000
Total	$110,000

AUTO COMPANY

Assets

Sundry assets	$532,000
Inventory of wheels	110,000
Investment in Wheel Company	88,000
Total	$730,000

Liabilities and net worth

Liabilities	$ 30,000
Capital stock	500,000
Surplus	200,000
Total	$730,000

The inventory of wheels shown on the balance-sheet of the Auto Company represents wheels sold to it by the Wheel Company at 10 per cent. profit. The surplus of the Wheel Company represents the profit made on the sale.

Now, if we elect to eliminate the whole of the inter-company profit of $10,000, we must deduct it either from the majority surplus alone or pro rata from both the majority surplus and the minority surplus.

If we decide to deduct the whole of it from the majority surplus, we shall have this effect:

Minority surplus, 20% of $10,000		$ 2,000
Majority surplus:		
Surplus of Auto Company	$200,000	
Surplus of Wheel Company, 80% of 10,000	8,000	
	$208,000	
Less—Inter-company profits	10,000	$198,000

In other words, we shall say to the stockholders of the Auto Company: "Your surplus is reduced from $200,000 to $198,000 because you purchased wheels from your subsidiary." To put it another way, we insist that the Auto Company cannot include the profit because it has only transferred the wheels from one company (department) to another, and no real *sale* takes place until the wheels are sold to an outsider; and yet we insist that by this transfer, on which no profit can be made, the company has made a loss! The inconsistency is very evident.

Now, on the other hand, if we decide to deduct it pro rata from the majority surplus and the minority surplus, the minority stockholders will say: "What, you say we have made no profit? Why not? We have sold $110,000 worth of wheels to the Auto Company and we have no interest in the Auto Company. So far as we are concerned, that profit is ours, and *it is all we can* *possibly make on the sale."* We cannot reply that the Auto Company is only another department of the Wheel Company; we cannot ignore the equity of the minority stockholders in this profit.

So there is no other course open than to add the minority's share of the profit to the inventory priced at the cost of the subsidiary's production, thus:

Inventory of wheels:

At cost of subsidiary's production	$100,000
Minority's share of intercompany profit	2,000
Total	$102,000

But when the minority interest is in the company buying the goods, the situation is different. Let us see how that may be. Assume a reversal of the condition. The Wheel Company owns 80 per cent. of the capital stock of the Auto Company. The balance-sheets at December 31, 1922, were as follows:

WHEEL COMPANY

Assets

Sundry assets	$120,000
Stock of Auto Company	80,000
Total	$200,000

Net worth

Capital stock	$195,000
Surplus	5,000
Total	$200,000

AUTO COMPANY

Assets

Sundry assets	$ 45,000
Inventory of wheels	55,000
Total	$100,000

Net worth

Capital stock	$ 50,000
Surplus	50,000
Total	$100,000

Again the inventory of wheels shown on the balance-sheet of the Auto Company represents wheels sold to it by the Wheel Company at 10 per cent. profit. The surplus of the Wheel Company represents the profit made on the sale.

Now we can eliminate the whole of the inter-company profit of $5,000 and support it by good argument. We can say to the stockholders of the Wheel Company: "The Auto Company is in reality a department of the Wheel Company, and you cannot make a sale on which a profit is realized by merely transferring the wheels from your company to the Auto Company. *There must be a sale made outside the combined companies.*" There is no loss to come back at us as there was under the first method in the previous case; there are no minority stockholders clamoring at us for recognition of their equity as there was under the second method in the previous case.

To sum up, we cannot avoid the minority's share of the profit in goods on hand with a related company when the minority holding is in the company which *sold* the goods. But when the whole of the profit has been taken up by the holding company—in other words, when the minority interest is in the company which *bought* the goods—the whole of the inter-company profit may logically be eliminated.