RESCINDED

RECONCILIATION OF INTERCOMPANY ACCOUNTS

Replaced - Refer to OCC Bulletin 2018-18

Overview

One of the most basic steps in evaluating the propriety of a parent savings association's accounting for its investment in subordinate organizations is to reconcile certain reciprocal accounts. Examples of this are the parent's loans receivable and investment accounts reconciled to loans payable and capital accounts of the subordinate organizations. The reconciliation of reciprocal accounts verifies that the parent association properly reflects on its accounting records adjustments in the investment carrying value. Also, the reconciliation process is an important step in ascertaining if the accounting for the subordinate organizations is in accordance with generally accepted accounting principles (GAAP).

The parent's books should reflect the various tiers of subordinate organizations in accordance with the appropriate GAAP method. The parent's percentage of ownership interest largely determines the method. As discussed in more detail below, a parent may record an investment in a subordinate organization under either the consolidated, equity, or cost methods of accounting, consistent with GAAP.

The term subordinate organization, which 12 CFR § 559.2 defines, includes a federal thrift's operating subsidiaries, service corporations, and their lower-tier entities (that is, entities owned directly or indirectly by a first-tier subordinate organization). A subordinate organization does not include entities in which a savings association invests in as a pass-through investment authorized under § 560.32. (Refer to Handbook Section 730 for a detailed discussion of subordinate organization examinations, or Section 230 for an overview of an association's pass-through investment authority.)

In a multi-tier organizational structure, the entities' intercompany accounts should be reconciled to reflect the operations of all subordinate organizations that have a material effect on the parent association's financial condition. It would be of little benefit to reconcile the accounts of the parent and a first-tier subordinate organization if the subordinate had not recognized a $1 million loss sustained by its lower-tier business venture. As part of the reconciliation process, a responsible party should first reconcile lower-tier entities' intercompany investments that have a material effect on the accounts of the association up through the subordinate organization corporate structure. Reconciliation of the lower-tier entities should precede reconciliation of the parent's records to the first-tier subordinate organization.

Consequently, the reconciliation process should begin with an identification of all subordinate organizations and their relationship to each other. Data necessary to accomplish this identification is available in the TFR Schedule CSS (Subordinate Organization Schedule) and in the Preliminary Examination Response Kit (PERK).

Before addressing the actual reconciliation process, a responsible party should identify some of the causes of differences between the parent's general ledger accounts and the subordinate organization's accounts. Differences in account balances can result from many circumstances. The more common reasons for differences include the following causes:

- Delays by the parent savings association in recognizing its proportionate share of the subordinate organization's net income or loss.
- Posting errors.
- Inadequate or improper accounting procedures.
- Differences in methods of accounting for payables and receivables.

The example that follows illustrates differences that result from delays in recognizing income or losses.

Example:

A common problem encountered in the accounting for investment in subordinate organizations is the timeliness of recording the results of the operations of subordinate organizations in the parent association's investment account. By delaying recognition of a subordinate organization's losses at year-end, the parent may try to shift the losses into the next accounting period. However, it is important that the results of a subordinate organization's operations be recognized in the appropriate accounting period to allow for a proper evaluation of the financial trends of the parent. In any case, the parent association should record the results of the subordinate's operations at least quarterly to provide complete and accurate reports to the regulatory agencies. (Monthly posting of the subordinate's operations is preferable to quarterly.)

A one-month delay in accounting for the investment in a subordinate organization is a common practice. Generally, financial data for the subordinate organization will not be available until several days past the end of a month. As a result, the parent does not know the necessary financial data at the time the parent makes the posting. If the recognition of the results of the subordinate organization's operations is consistently posted one month late and there are no material changes in the unposted month, you need not take exception. If monthly net income or losses are material to the financial condition of the parent, you should recommend that management make an accrual for month-end financial statement presentation based on an estimate of the most recent month's operations.

You should consider the assessment of the financial condition complete only after verifying that the parent association has properly recognized and timely recorded the financial effect of the subordinate organization. However, you must use judgment in evaluating the importance of a variance in account balances. The key factor to consider is whether the variance misrepresents the financial condition of the parent association. Another factor to consider is the cause of the account variance. Was the cause human error, inappropriate accounting procedures, or intentional misrepresentation? You should bring any account variances to the attention of management for resolution. However, you should pursue for examination purposes only those variances that misrepresent the financial condition of the parent association or appear to result from inappropriate procedures or intentional misrepresentation.

Overview of Reconciliation Process

Initially, you should determine if the internal accounting staff has already made a reconciliation of accounts. You should test the reconciliation for accuracy. Generally, the reconciliation process involves two basic categories of accounts, namely, investment and reciprocal capital accounts, and intercompany payable and receivable accounts. In many instances, the reconciliation of these accounts is part of the internal or administrative control procedures for the subordinate organization or savings association.

The actual reconciliation process is relatively mechanical. The first step is to identify all capital accounts on the working trial balance for the subsidiary. These generally include the following accounts:

- Common and preferred stock.
- Paid-in-capital.
- Undistributed current earnings.
- Retained earnings or deficit.

You can also identify investment accounts from the parent's working trial balance. Examples include the following accounts:

- Common stock of subsidiary.
- Investment in subsidiary.
- Investment in service corporation.
- Investment in joint venture.
- Investment in operating subsidiary.

Next, total all the investment accounts and the related capital accounts and compare the totals. You should investigate any material differences to determine the reason for the variance.

The following examples illustrate the reconciliation process under the consolidated and equity methods of reporting. The following also provides a discussion of the cost method. The cost method, however, does not involve the reconciliation of intercompany accounts, other than to ensure that the parent's books reflect as income dividends received from subordinate organizations.

Reconciliation of Investments and Capital Accounts

Consolidation

When a savings association owns more than 50 percent of a subordinate organization's outstanding common stock, GAAP generally requires the association to consolidate the subordinate's assets on its financial reports. In a consolidation, the association's financial reports reflect the financial position, operating results, and cash flows of both the parent and subordinate as if they were a single business entity. Consolidation occurs even though the entities maintain their separate corporate identities. In preparing consolidated reports, the reconciliation process involves the elimination of intercompany accounts. For example, in a consolidated financial statement, the entities eliminate intercompany loans between the parent and subordinate organization. They do this by crediting the parent's note receivable from the subordinate on the parent's books and by debiting the note payable to the parent company on the subordinate's books. From a consolidated entity viewpoint, an intercompany loan transaction simply results in the transfer of cash from one part of the entity to another and does not cause a receivable or payable.

Consolidations are usually complex. Because of this, the parent and subordinate generally prepare worksheets to support the consolidation of assets, liabilities, and income items and certain elimination and adjustment entries. Typical intercompany elimination entries pertain to intercompany stock ownership, intercompany debt, and intercompany revenue and expenses. This includes open account balances, security holdings, sales and purchases, interest, dividends, gain or loss on transactions among companies in the consolidated group, and intercompany profit or loss on assets remaining within the group.

When a subordinate organization is majority (but not wholly) owned by a parent association, the subordinate separately reports the minority interest of shareholders owning less than 50 percent of outstanding voting common stock. The minority shareholders have an interest in the subordinate's net assets and in earnings or losses.

You should consult Accounting Principles Board Opinion (APB) No. 16, Business Combinations, when there are complex consolidation matters, such as intercompany profits in assets, goodwill, and income taxes on undistributed earnings.

The following example illustrates the consolidation of a parent company and its subordinate organization, ABC Company. Assume the parent owns 60 percent of ABC Company. By owning more than 50 percent of ABC's outstanding voting common stock, the parent combines its assets and liabilities with 100 percent of ABC's assets and liabilities. However, an entry to eliminate the parent's investment in ABC is necessary to keep from double counting the investment.

Assume that common stock and paid in capital ($1,500,000) plus retained earnings ($500,000) total $2,000,000. The accounting entry will eliminate the parent's $1,200,000 investment account in ABC and ABC's stockholders'equity accounts on the combined parent company and subsidiary working trial balance sheet. The entry to record the minority interests is as follows:

(000's omitted)

	debit (credit)
Common Stock and Paid-in Capital – ABC Company	$1,500
Retained Earnings and Undistributed Income – ABC Company	$500
Investment in ABC Company	($1,200)
Minority Interest	($ 800)

The $800,000 represents the remaining 40 percent interest that the parent company does not own. Technically, minority interests are not liabilities since there is no payment obligation to anyone. In practice, however, a parent's consolidated balance sheet may show minority interests as liabilities, but the usual practice is to show minority interests between liabilities and stockholders' equity.

The parent company stockholders' equity accounts do not change. For example, as the following summary format shows, the parent company stockholders' equity and retained earnings accounts total $4,400,000 before and immediately after the consolidation. Thus, consolidation does not affect these account balances.

After the parent eliminates the subordinate organization's investment accounts and makes other accounting entries to eliminate the intercompany debt and receivables, the parent combines its remaining assets and liabilities with the subsidiary's remaining assets and liabilities. These entries also combine the parent company stockholders' equity account, including the minority interests, for the consolidated financial statements, as shown below in summary format.

(000's omitted)

	Parent	Subsidiary	Eliminating Entries	Consolidated
Assets	$ 51,100	15,100	($ 1,200)	$ 65,000
Liabilities	(46,700)	(13,100)	--	(59,800)
Minority Interests	--	--	(800)	(800)
Stockholders' Equity	(4,400)	(2,000)	2,000	(4,400)

Equity Method

When a parent savings association owns between 20 and 50 percent of a subordinate organization's outstanding voting common stock, the parent should generally reflect the investment on its books under the equity method. The parent initially records its investment in the entity at cost. The parent makes subsequent adjustments to the carrying value to reflect its share of the subordinate's earnings or losses in the period that the subordinate reports its operating results. Also, the parent adjusts its investment to reflect dividends received from a subordinate organization. Under the equity method, the parent does not report a subordinate organization's dividends as income, but rather as cash dividends that reduce the subordinate's net assets (and stockholders' equity). Accordingly, the parent should record a proportionate decrease in its investment account for dividends received from the subordinate organization.

The equity method may require other adjustments to the investment account similar to those made in preparing consolidated statements. These include eliminating intercompany gains and losses and to account for any differences between the parent and the subordinate organization in the measurement of the subordinate's expenses (for example, depreciation).

In the following illustration of the equity method, assume that a review of the subordinate organization's records establishes that the savings association owns 40 percent of ABC. Accordingly, the association's investment should reflect 40 percent of the net book value of ABC. However, after examining the working trial balance for the parent association shown below, the investment account for ABC is $10,000 short ($2,000,000 x .40 = $800,000 and $800,000 - 790,000 = $10,000). It is apparent that the investment accounts on the parent's general ledger do not balance with the capital accounts of the subordinate organization.

(000s omitted)

Capital Stock of ABC	$	700
Share of ABC Income		90
Total	$	790

The working trial balance for ABC Corporation contains the following capital accounts:

(000s omitted)

Common Stock	$	500
(500 Shares, $1000 Par)		
Paid-in Capital		1000
Undistributed Current Earnings		200
Retaining Earnings		300
Total	$	2000

You must determine the cause of the difference to complete the reconciliation. One common cause of such a variance is a delay in the posting of the subordinate organization's monthly income to the parent's investment account. By reviewing the previous month's financial statement for ABC, you determine that net undistributed income was $175,000 for the prior month. This indicates that the net income of ABC for the most recent month was $25,000 ($175,000 + 25,000 = $200,000, the amount of ABC's undistributed current earnings). The parent savings association's share of the net income was $10,000 ($25,000 x .40). The reconciliation should appear as follows:

(000's omitted)

Parent's Total Investment	$	790
Plus: Parents Share of Current Month Income Recognized After Month's End		10
Parent's Proportionate Share of ABC's Total Capital	$	800

You may consult APB No. 18, The Equity Method of Accounting for Investments in Common Stock, for more detail on the equity method.

Reconciliation of Intercompany Payables and Receivables for Consolidated Financial Statements

You should identify all intercompany payables and receivables that the parent must reconcile. The parent should reconcile such intercompany transactions prior to eliminating them on the consolidated financial statements. Examples of intercompany payables and receivables include the following accounts:

- Loans and advances
- Income tax payables and receivables
- Accounts payable and receivable.

Generally, the parent association or subordinate organization reconciles only those accounts that are material in relation to their financial position. The parent or subordinate may, however, reconcile routine accounts payable and receivable even though they may not warrant reconciliation due to their small amounts.

You can identify intercompany payables and receivables by reviewing the working trial balances of the subordinate and the parent. In cases where the general ledger account name is inconclusive, you should interview the accounting staff. Also, in some instances it may be necessary to use general ledger subordinate organization records to identify the accounts that you must reconcile. For example, in most instances a parent association will not segregate a mortgage loan to a subordinate organization on its general ledger. In such cases, you must use the parent's mortgage loan trial balance in the reconciliation process.

After you identify the accounts, you must total each of the intercompany payables and receivables accounts and compare the related totals. You should investigate any material differences to determine the reason for the variance. An example of a common reconciliation of intercompany payables and receivables follows:

ABC Corporation has two loans shown as payable to its parent on its general ledger trial balance as follows:

(000's omitted)

Note Payable Parent	$	540
Mortgage Loan Payable		927

A review of the general ledger trial balance for the parent association reveals an account entitled Unsecured Note Receivable ABC for $540,000. However, the parent does not segregate the mortgage loan on its general ledger trial balance. You must therefore obtain the mortgage loan trial balance to reconcile the mortgage loan payable. After you obtain the loan number from subordinate organization personnel, you can identify the loan on the parent association's mortgage loan trial balance. However, the trial balance lists the loan balance as $1,200,000.

To reconcile this difference quickly and efficiently, you must be aware of the types of activities conducted by the subordinate organization. If the entity engages in any construction activities, review the loans-in-process balance. Information about loans-in-process may be part of the mortgage loan trial balance or a completely different report. The loans-in-process balance for this particular loan was $245,000, which gives a net loan balance of $955,000, or $28,000 more than reported by ABC. A common cause for this type of variance is a timing difference in recording disbursements between the parent and the subordinate organization. To identify timing differences, you should review the loans-in-process transaction history and the subordinate organization's mortgage loan payable general ledger account history near the end of the month when the entity usually reconciles accounts.

You should look for disbursements that the mortgage loan payable account does not reflect, or repayments by the subordinate that the loans-in-process account does not reflect, until after the end of the month. In this instance, the subordinate made a disbursement of $47,000 on the last day of the month but did not post it to the mortgage loan payable account until the first of the next month. Also, the subordinate closed a sale of a developed residential building lot on the last day of the month and issued a check for $19,000 to the parent to replenish the loans-in-process account. ABC posted this check to its mortgage loan payable account on the last day of the month but the parent did not post it until the second day of the next month. The reconciliation of the mortgage loan payable should be as follows:

(000's omitted)

Mortgage Loan Receivable Per Parent Trial Balance	$	1,200
Adjustments:		
Less: Loans-in-Process		(245)
Less: Disbursements Posted After Month's End		(47)
Correct Total for Parent Trial Balance	$	908
Mortgage Loan Payable Per ABC's Trial Balance	$	927
Adjustments:		
Less: Repayments Posted After Month's End		(19)
Correct Total For ABC's Trial Balance	$	908

Cost Method of Reporting

Under the cost method, the parent records its investment at cost, and recognizes as income subsequent dividends received that are distributed from net accumulated earnings of the organization. However, OTS considers dividends received in excess of earnings subsequent to the date of investment as a return of investment. Parent associations, consequently, should record dividends that the subordinate pays it in excess of its share of earnings, as a decrease in the cost of the investment. To determine whether a dividend payment is a "liquidating" dividend or an ordinary dividend, you can compare cumulative earnings and dividends.

Reporting Examination Findings

As previously noted, you should investigate only those variances that are material in relation to the parent savings association or the subordinate organization. Compare the variance with the capital and net income of the parent entity to determine the materiality of the variances for the individual subordinate organizations. You should document any material differences in the examination work papers with an explanation for the cause of the discrepancy. You should also identify the appropriate treatment or necessary adjustments within the same work papers. If necessary, initiate refilings of the appropriate regulatory financial reports by the subordinate organization and parent association.