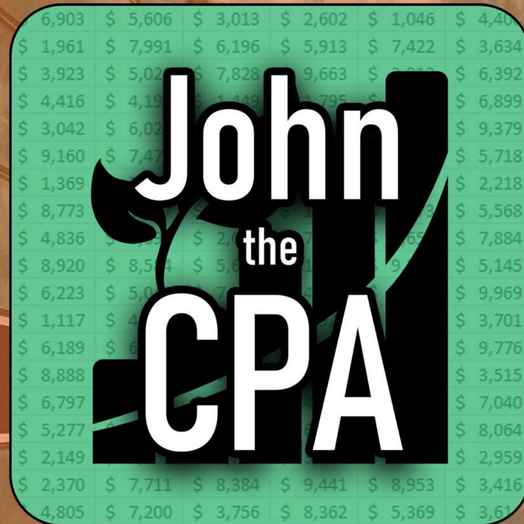

A Simple Guide to Intercompany Transactions

Purpose

Accounting for intercompany transactions is one of the most difficult operational obstacles in a small business. When an organization is large enough to effectively use multiple financial reporting units in the ordinary course of business, the thought of accounting for all entities combined is not likely to be high on the list of priorities until the annual financial statement audit or review. Additionally, every organization learns the process differently, and as a result will develop a different way of keeping track of intercompany transactions. The guide has been built as a reference for both the person who is encountering intercompany transactions for the first time, as well as experienced individuals who would like to refine their framework for understanding and managing these transactions for their business.

This guide will provide a brief overview of what intercompany transactions are and how they occur, and then immediately jump into common examples of intercompany transactions and the best practices surrounding them. While it is not meant to be a complete guide for your organization, it aims to serve as a simple guide to the nature and practices surrounding intercompany transactions so that you can develop your own practices and methodologies that work best with your organization.

What is an Intercompany Transaction?

An intercompany transaction is a transaction between two related entities that are further bound by a financial reporting relationship. This includes parent companies and subsidiary companies as well as companies reporting as a consolidated entity (such as under VIE rules). The transactions between these companies represent information that is useful to investors and creditors only if the entities are reporting separately. If companies are reporting together and have such transactions, they need to be eliminated from the financial statement presentation, so they don't mislead the users of the financial statements.

Every entry in accounting has the beautiful symmetry of equal debits and credits. Intercompany transactions take this one step further and create a symmetry between the two entities involved. Every intercompany transaction is guaranteed to have corresponding amounts on each entity's books: a payable one the books of one company is a receivable on the books of the other company. Because of this property, all intercompany transactions and balances recorded across both entities should net to zero.

A common question people ask related to intercompany transactions is: "What is the difference between an intercompany transaction and a related party transaction?" While the precise and practical definition of these terms will vary slightly from person to person, in this document, Intercompany transactions are those that require that the companies to be reporting together as a part of the same consolidated or combined entity, whereas related party transactions have a much broader definition. Board members, owners, profit sharing trusts, members of senior management, and affiliates can all be considered related parties to a company. If entities that usually report under a consolidated or combined structure are reported separately, the transactions and balances that would have been considered intercompany transactions in the consolidated report would be considered related party transactions in the standalone report. In either case, having processes in place to separately track the activity is highly recommended.

Examples of Intercompany Transactions

Due to Affiliate – Due from Affiliate	
Company A made a payment to a vendor on behalf of Company B for office supplies. The supplies were delivered and used by Company B.	
Debit – Due from Affiliate Credit - Cash	Debit – Office expense Credit – Due from Affiliate

This instance of having a short term payable/receivable on the companies' books is very common when the entities are under common control and interact with or on behalf of one another in the ordinary course of business. If management likes to keep the business units separate or would like to treat each unit as a standalone entity where possible, it is recommended that the due to/from affiliate accounts are at least checked (if not paid off in cash) each month so that each entity's monthly true cash flow obligations are properly understood.

Note Payable (Affiliate) – Note Receivable (Affiliate)	
Company A issues a note to Company B in the amount of $100,000. Interest accrues at 6% and is payable annually.	
Debit – Notes Receivable (Affiliate) Credit – Cash	Debit – Cash Credit – Notes Payable (Affiliate)

Another common occurrence is for an affiliate entity to loan funds to its affiliate in a time of need or to fund certain projects. Due to the nature of a note agreement between entities, business like to have these notes in writing with established amounts, due dates, and interest terms. The amounts owed on the principal of the notes and the interest paid during the financial reporting period will need to match up 1:1 on each entity's books. As with every transaction with a related party, it is wise to keep these amounts in a separate general ledger account to keep them separate and easily identifiable for financial statement disclosures.

Investment in Affiliate - Equity	
Company A purchases 20% of the Common Stock of Company B. 2000 Shares @$50 per share	
Debit – Investment in Company B Credit - Cash	Debit – Cash Credit – Common Stock / APiC // Equity

When one company has ownership of another company, the amount is recorded as an investment on the owner's books, and as equity on the investee's books. These arrangements are common in certain industries that encourage separate legal entities for certain operations, or joint venture activities. While standards may require the consolidation of these separate entities in certain circumstances, it is important to maintain the separate sets of books with the amounts involving related parties clearly identified. Depending on the equity structure of the investee, the of accounts used to record the equity investment may change.

Revenues - Expenses Company B uses services from Company A to support work on a contract	
Debit – Intercompany AR / Cash Credit – Intercompany Revenue	Debit – Intercompany Expense / Subcontractor Expense Credit – Intercompany AP / Cash

Intercompany revenues and expenses are very common when the entities have a parent-subsidiary relationship, or a company and its joint venture with another company. These types of relationships are common when companies have distinct employees and services or are obligated to perform certain tasks out of a certain legal entity. Depending on the accounting system in use, it may be easier to report the revenue in the standard revenue module. Generally, it makes sense for the company receiving the benefit of the services to create a separate account in this instance for the separate expense such as "Subcontractor expense – affiliate." Having an account that separates the related expenses is much easier and manageable for some companies.

Interest Income – Interest Expense Company B pays interest to Company A on the note the Company A issued to Company B	
Debit – Cash Credit – Interest Income (Affiliate)	Debit – Interest Expense (Affiliate) Credit – Cash

This scenario is commonly overlooked when it comes to intercompany reconciliations since the interest expense and income are not a component of operating income. Many smaller companies don't distinguish intercompany interest in a separate account since there aren't too many financing arrangements on the books, making it easy to pick out. In any circumstance, the amounts for interest, along with the corresponding notes, need to be identified for financial reporting purposes – either as a related party note in a single statement presentation, or an eliminated intercompany expense in a combined or consolidated presentation.

Best Practices and Helpful Tips

Remember the Golden Rule of Intercompany Balances

"Every intercompany transaction has an equal and opposite component recorded on the second set of books" - As noted above in the examples, each company should have the amounts for transactions recorded separately on their books. A good thing to remember while recording these transactions is that because the amounts should correspond directly to the other set of books, communicating with the person who is responsible for recording the transaction for the other company can eliminate a lot of headache.

Record Balances with Related Parties Using Similar Account Numbers

While recording intercompany and related party transactions may be intuitive to some, it is certainly not intuitive to everyone. To help everything go smoothly, it is a great idea to use similar account numbers and naming conventions across the entities to make it easier to match up the accounts when comparing the two sets of books. Here is an example:

Alpha Company		Beta Company	
Account Number	Account Description	Account Number	Account Description
1800	Due from Beta Company	2800	Due to Alpha Company
1850	Note Receivable – Beta Company	2850	Note Payable – Alpha Company

Maintain a Consolidating Schedule to Match All Accounts and Reconcile Monthly

If the entities will be reporting on a consolidated or combined basis, it is essential that all the intercompany balances sum to zero. Companies that experience intercompany transactions in the ordinary course of business can function like a single unit outside of the financial reporting process. This makes it so the tracking of payments from a business standpoint can get difficult because although the entities may be separate on paper, the actions taken by the accounting personnel mix between all the reporting entities, which can make it harder to remember where a payment should go. By creating and maintaining a consolidating schedule and reconciling it on a monthly basis, any differences between the intercompany accounts can be quickly identified and remedied, instead of being left alone for 6 months. Remember, there should always be equal and opposite corresponding balances!

Periodically Examine and Close Out Due to/from Affiliate Accounts

Sometimes an entity will accumulate minor balances for payments made on behalf of the other company, and the amounts are never paid back. When this happens, the due to/from accounts become filled with many smaller transactions that effectively have zero substance. To clear out these accounts, the companies can settle the due to/from with a cash payment to settle the balance or recording intercompany income / expense to forgive the debt owed during the reporting period.

Separate Intercompany Balances from Trade AP/AR

Within QuickBooks especially, it is very easy to set up a vendor or customer for the other company to simplify the process. By default, this relationship is recorded as a standard customer or vendor relationship, and therefore the balances would sit in on the respective AP and AR aging reports of the company, which can complicate the reconciliation process since the amounts would be including with standard customers and vendors.