

## SOME CHALLENGES IN THE CONSOLIDATION OF UNREALIZED INTRA-GROUP PROFITS AND LOSSES



UDC 657.375

Vojislav Sekerez<sup>1</sup>, Dejan Spasić<sup>1,2</sup>

<sup>1</sup>University of Belgrade, Faculty of Economics and Business, Republic of Serbia

<sup>2</sup>University of Niš, Faculty of Economics, Republic of Serbia

ORCID iD: Vojislav Sekerez  
Dejan Spasić

 <https://orcid.org/0000-0003-1009-0524>  
 <https://orcid.org/0000-0002-8540-579X>

**Abstract.** *Procedures for eliminating internal results in practice may vary due to the different nature of the relationship between related parties, but also due to the vagueness of the accounting regulation, which opens up space for alternative procedures in practice. The ways of eliminating internal profits and losses differ primarily depending on whether full consolidation of financial statements or one-line consolidation, followed by the application of the equity method, is performed. At the same time, with both mentioned consolidation procedures, questions are raised regarding whether downstream and upstream transactions should have the same treatment, that is, whether the total internal result should be eliminated or only its part that is proportional to the ownership share. The aim of this paper consists in analyzing specific issues of eliminating internal results, while considering the current state and the possibility of improving accounting regulations in that field.*

**Key words:** *consolidated financial statements, separate financial statement, one-line consolidation, intercompany transactions, internal results, equity method.*

**JEL Classification:** M41

### INTRODUCTION

Consolidated financial reporting has been subject to dynamic regulatory changes in recent decades due to global harmonization efforts. In fact, the need for harmonization and improvement of the principles and methods of consolidation is caused not only by the

---

Received July 06, 2023 / Revised October 22, 2023 / Accepted November 03, 2023

**Corresponding author:** Vojislav Sekerez

University of Belgrade, Faculty of Economics and Business, Kamenička 6, 11000 Belgrade, Republic of Serbia

| E-mail: [vsekerez@ekof.bg.ac.rs](mailto:vsekerez@ekof.bg.ac.rs)

creation of new instruments and possibilities for exercising control by the parent company over the subsidiary, but also by the complexity of intra-group transactions (Spasić & Sekerez, 2022, p. 20). It is known that generally accepted accounting principles, that is, the conceptual framework and accounting standards are based on theoretical concepts and requirements of business practice (Needles, Powers, & Crosson, 2011). Therefore, the "practice of introducing new and more complex concepts through a series of progressive changes" (Peng & van der Laan Smith, 2010, p. 24) requires a permanent review of both the regulation and the practice of corporate reporting. Regardless of the approach to creating standards (based on principles or rules where there are still significant differences - Guillaume & Pierre, 2016), complex accounting issues must be addressed very carefully. Group reporting is particularly affected by complexity of intragroup transactions, which also requires careful creation and application of financial reporting standards. Therefore, Brown, Huffman and Cohen (2023, p. 43) point out that "the nature and volume of accounting standards and diversity in the treatment of similar transactions are key sources that tie directly to mandatory accounting guidance and the resulting disclosures".

The key challenges of consolidated financial reporting since the beginning of the 21st century are largely a consequence of changes in accounting standards. More recently, research has been predominantly focused on the new concept of control and its implications on consolidated financial statements (Hsu, Duh & Cheng, 2012; Ben-Shahar, Sulganik & Tsang, 2016; Beck et al., 2017; Bedford, Bugeja & Ma, 2022), goodwill accounting (André, Filip & Paugam, 2016; Li & Sloan, 2017; Amel-Zadeh, Glaum & Sellhorn, 2023; Just, Honold & Meckl, 2023), including other intangible assets acquired in a business combination (Skinner, 2008; Su & Wells, 2018; Tunyi et al., 2020; Barker et al., 2022), accounting treatment of non-controlling interests (Lopes, Lourenço & Soliman, 2013; Welc, 2017; Sotti, 2017; Lopes et al., 2021) and other specific reporting areas in accordance with the acquisition method.

Other areas of financial statement consolidation seem to have been neglected in recent research. Although calculating, recording and eliminating the effects of common intercompany transactions within the group may be viewed as "routine" matters, there is still a need for their ongoing review and discussion. Our aim is therefore to highlight and discuss specific challenges in eliminating unrealized profits or losses under both the acquisition method and the equity method, as well as the implications of the chosen method in the event that the parent company prepares separate financial statements.

The importance of our research stems from the fact that the elimination of internal results is a challenge both for professional accountants and for the study of this matter at academic level and/or through professional trainings. In other words, "teaching and learning accounting for consolidations is a challenging endeavor" (Murphy & McCarthy, 2010, p. 101). Although there is research on how to teach consolidated accounting (Murphy & McCarthy, 2010; Churyk & Stenka, 2014; Hsiao & Han, 2021), our goal is not to educate, but to renew the discussion on the specific issues of financial statement consolidation, especially the treatment of unrealized intra-group results.

Accounting for intra-group profits and losses affects the reliability of the analysis of consolidated financial statements (Aceituno et al., 2006), i.e. their value relevance (Abad et al., 2000; Hevas et al., 2000; Srinivasan & Narasimhan, 2012). Therefore, our goal with this paper is also to renew the interest of professional accountants including financial analysts in this topic.

One of the key tasks during the process of consolidating financial statements consists in eliminating intragroup transactions between related entities in order to show the financial position of the group and the success it has achieved in relations with its environment. This implies the elimination of internal revenues and expenses, as well as all internal results that, as a rule, arise during mutual transactions between companies within the group. Eliminating internal results primarily involves identifying the internal transactions on the basis of which they arise, which may refer to the sale of inventory and fixed assets, the provision of various services or financing. Regardless of the nature of internal transactions, which can be very diverse, they can all be broadly grouped into the following four categories (Krimpman, 2015):

- transactions for immediate sale (further sales occur in the same period);
- transactions for later sale (resale occurs in the following period);
- transactions for own use;
- transactions for own consumption.

The method of eliminating internal results will depend not only on which of the aforementioned categories of transactions they refer to, but also whether they are contained in tangible assets, intangible assets or services. Even when it comes to internal results contained in tangible assets, the method of their elimination differs depending on whether they are contained in goods, finished products, work in progress, material incorporated into finished products, or fixed assets. Also, the elimination of internal results will be determined by the applied method of calculation of results, that is, whether the profit and loss statement is compiled by function or by nature. The four basic transactions (for immediate sale, for later sale, for own use and for own consumption) rule the lines in the balance sheet and profit and loss statement that have to be used for elimination, both on the sender's and receiver's side. In summary, the way of elimination of internal results will depend on the following factors:

- type of transaction (four types);
- subject of transaction (goods, materials, finished products, services etc.);
- method of calculation of result (by nature, by function);
- consolidation method (equity method, full consolidation);
- direction of transaction (downstream, upstream).

The listed factors are interconnected, so all of them should be taken into account when considering a specific situation.

In the paper, we will focus on the elimination of internal results contained in inventories when it comes to transactions for later sale and assuming that the profit and loss statement is compiled by nature. The specifics of eliminating internal results in the aforementioned circumstances will be analyzed, with a parallel consideration of how to eliminate them under the conditions of applying the equity method (one-line consolidation) and the method of full consolidation of parent company and subsidiaries. The common feature of both methods is that the internal results cannot be considered realized from the point of view of the group, until it comes to a sale to outside party. Finally, the paper will consider the specifics of eliminating internal results during downstream and upstream transactions, both under applying equity method and full consolidation.

### 1. ELIMINATION OF INTERNAL RESULTS FROM ENDING INVENTORY – FULL CONSOLIDATION

In general, it is undisputed that the profit or loss resulting from transactions between companies within the consolidation group should be eliminated while simultaneously adjusting the book value of the ending inventory in the consolidated balance sheet. According to the guidelines in IFRS 10.B86, "...profits or losses resulting from intragroup transactions that are recognised in assets, such as inventory and fixed assets, are eliminated in full."

Since transactions can occur downstream (sales from a parent to a subsidiary) and upstream (subsidiary sells to parent), a question may arise about the treatment from a group perspective of non-controlling interests (NCI)-related unrealized gains or losses. In the case of downstream transactions, this problem does not arise, because NCIs do not participate in the parent's ownership. However, NCI may be affected if a partially-owned subsidiary sells to the parent an asset that has not been externally realized at the reporting date. Apart from the general approach defined in the already cited IFRS 10.B86, IFRS does not contain explicit guidelines for recognizing the share of NCI in unrealized profit or loss. On the other hand, US ASC 810-10-45-18 allows a choice between two approaches. Namely, elimination of unrealized profit or loss in upstream transaction may either be fully attributed to the parent, or attributed proportionately between the parent and NCI. The first approach is in the line with the basic assumption that consolidated financial statements show the financial position and results of the consolidated group as a single economic entity.

However, if NCI's share of unrealized profit is not taken into account, the net profit attributable to the parent company may be underestimated. For this reason, Beams et al. believe that "the second approach that allocates unrealized profits and losses from upstream sales proportionately between noncontrolling and controlling interests is conceptually superior because it applies the viewpoint of the consolidated entity consistently to both controlling and noncontrolling interests" (Beams et al., 2018, p. 175).

It is important to note that the FASB does not permit the use of this approach when dealing with an upstream transaction involving a consolidated variable interest entity. Although the first approach is less complex, the second approach would still have an impact on the analytical value of the consolidated financial statements, not only from the perspective of minority shareholders but also with regard to the information needs of financial analysts. In other words, the existence of NCIs and their adequate accounting treatment is an important determinant of the value relevance of consolidated financial statements (Sotti, 2017).

The issue of NCI's share in unrealized profit or loss is also important for intragroup transactions between subsidiaries. If the transaction involves partially owned subsidiaries, the elimination of the unrealized profit or loss should generally be consistent with the accounting principles for sales to the parent company. In other words, in such transactions, if the selling subsidiary is partially-owned, NCI's share of the unrealized profit or loss should be also determined.

In addition to the issue of eliminating unrealized gains and losses attributable to the NCI, deferred taxes may arise on intercompany sales. This is pointed out in continuation of the already cited IFRS 10.B86: "IAS 12 Income Taxes applies to temporary differences that arise from the elimination of profits and losses resulting from intragroup transactions."

Temporary differences arise in a transaction that changes the tax basis of the goods that are the subject of the purchase transaction (IAS 12.18(e)). In this case, the temporary difference is the result of eliminations within the group, i.e. the unchanged book value of

assets or liabilities in the consolidated financial statements. In other words, “the problem of deferred-tax accounting in group accounts is essentially the problem of a difference between the accounting entity and the tax entity” (van Hoepen, 1981, p. 168).

Basically, “deferred tax assets and liabilities shall be measured at the tax rates that are expected to apply to the period when the asset is realized or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period” (IAS 12.47). In addition, IAS 12 generally requires that “entity measures deferred tax liabilities and deferred tax assets using the tax rate and the tax base that are consistent with the expected manner of recovery or settlement” (par. 51A). Consistent with this requirement, deferred tax should be measured at the tax rate of the buying company, not the seller. However, this rule should be reconsidered if the requirements of a country's tax authorities impose special rules regarding the tax history of assets or liabilities. In other words, for the purposes of measuring deferred taxes in consolidated financial statements, the general principles of IAS 12 should be re-considered as to which tax rate to apply.

The previous brief overview of the main issues of eliminating unrealized profit or loss in parent-subsidiary transactions remains challenging for both regulators and practitioners, which is why we consider these issues important for the wider academic community as well. However, the effects of transactions with associates and joint ventures have no less importance on the information power of consolidated financial statements, which will be discussed below.

## 2. ELIMINATION OF INTERNAL RESULTS FROM ENDING INVENTORY – EQUITY METHOD

For the purpose of “counting for investments in associates or joint ventures, over which the investor exercises significant influence or joint control, it is necessary to use the equity method”, according to IAS 28. It is the accounting method whereby “the investment is initially recognized at cost and adjusted after the acquisition date for the changes in the investor's share of the net assets of the investee” (IAS 28.3). In contrast to the full consolidation of subsidiaries, the equity method implies an on-line consolidation procedure, during which only the investment in the associate or joint venture is consolidated in the investor's balance sheet. However, regardless of the differences in the consolidation process between the equity method and full consolidation, when eliminating internal results, both methods start from the same initial idea that the results contained in internal transactions must be deferred until the inventory is sold to third parties. This means that internal sales transactions between the investor and the investee are viewed in the same way as transactions between parent and subsidiaries, due to their interconnection resulting from the significant influence of the investor. Therefore, there is a need to eliminate all internal transactions and internal results that arise on that occasion, as well as during the full consolidation of financial statements.

Therefore, in the case of transactions for later sale, in which the inventory will be resold to an unrelated party in the subsequent period, because from the point of view of the group, the earning process is not considered complete until the final disposition of goods to the external buyer.<sup>2</sup> When the equity method is applied, transactions between

---

<sup>2</sup> On the other hand, in the case of transactions for immediate sale, internally purchased stocks are sold externally in the same period when they were bought, so the complete result is realized and there is no need for its deferment, i.e. eliminating it from the group's financial statements.

related parties can also be classified as either downstream or upstream transactions. Downstream sales refer to investor's sale of goods to the investee, while in upstream sales investee sells the goods to investor (Hoyle, 2011). The direction of intercompany sales does not affect the way of eliminating internal results in a situation where there is significant influence (or joint control) of the investor. However, direction of internal transaction will cause serious differences when there is control, i.e. when the parent company applies the equity method. In this part of the paper we will present the elimination of internal results in the case of the basic application of the equity method, when there is a significant influence (or joint control) of the investor, while the application of this method by the parent company will be discussed in the following parts of the paper.

**Downstream sales** result in a situation where the internal profit (or loss) is contained in the inventory of the investee (associate or joint venture), as a buyer or sending company, and in the income of the investor (ultimate parent or any subsidiary), as a seller or receiving company. The elimination of the internal result is not done in its entirety, as in the case when the investor has control over a subsidiary company, but only proportionally to the amount of investor's participation. For the amount of the corresponding part of the investor's internal profit, which is the subject of elimination, the amount of his investment, as well as the income from that investment (calculated in the amount of the part of the net profit of the investee that belongs to the investor), are simultaneously reduced. Conversely, in case of an internal loss, the investment and income would be reduced at the same time.

*Example:* Assume that company A sold goods for 100,000 to company B, in which it has a 30% interest and significant influence. The sales value of the goods includes the investor's profit of 30,000. By the end of the year, Company B has sold half of that stock to external customers, while the other half of the goods are still in stock at the balance sheet date.

*Solution:* Of the total profit of the investor, only one half (15,000) can be considered realized, while the remaining 15,000 contained in the unsold inventory of company B must be eliminated. Given that the investor's participation is 30%, he eliminates the same percentage of the internal result, i.e. the amount of 4,500 ( $15,000 * 30\%$ ), by reducing the value of its investment and income from that investment.

**Upstream sales** lead to the situation that the internal profit is contained in the inventory of the investor, who is now in the role of the buyer, as well as in the income and result of the investee, as the seller. Receiving company as a buyer may be ultimate parent or any subsidiary of the group. The elimination of the internal result is done in the same way as in the case of downstream transactions, which means that the investor eliminates a proportional part of the total internal result by simultaneously reducing the amount of equity investment and the income from that investment.

*Example:* Associate B sold to investor A (who exercises significant influence over B) goods for 80,000, with a profit of 20,000. At the end of the year, company A still has a quarter of those goods in stock, while the rest was sold to external customers.

*Solution:* At the end of the year, company A owns internally procured goods worth 20,000 ( $80,000/4$ ), which includes an internal profit of 5,000 ( $20,000/4$ ). Company A owns a 30% interest in associate B, so, according to the equity method, it eliminates only the internal profit of 1,500 ( $5,000*30\%$ ). Therefore, company A, as an investor, will simultaneously reduce the value of its investment and the income derived from it by the amount of 1,500.

### 3. SHORTCOMINGS OF EQUITY METHOD ACCOUNTING FOR INTERCOMPANY PROFIT TRANSACTIONS

“Notwithstanding the widespread use of the equity method and its positive characteristics, primarily in the domain of providing relevant and useful information on the real economic value of equity investments, this method also exhibits certain shortcomings in practice” (Škarić-Jovanović, 2014). Here we will briefly analyze the shortcomings of equity method accounting treatment of intercompany profit transactions.

The IASB has so far conducted several studies related to transfer of assets between an investor and its associate or joint venture under the equity method accounting. Some of the results suggested the need for amendments to IAS 28 (28.31) to clarify the accounting for downstream transactions in conditions where the internal gain from the transaction exceeds the carrying amount of the investor’s interest in associate or joint venture (Bradbury, 2018). Namely, IAS 28 does not offer strict guidelines for situations when the amount of the internal profit “to be eliminated is higher than the carrying amount of the interest in associate”. Krimpman (2015) suggests the following solutions that can be applied in practice in that case:

- no elimination of internal profit
- internal profit should be deferred as a separate component of equity or income
- loss recording during the elimination of internal profit.<sup>3</sup>

Another problem in this field is inconsistency between IFRS 10 and IAS 28 regarding the treatment of intercompany profit transactions. Namely, IAS 28 refers to IFRS 10 emphasizing that “many of procedures that are appropriate for equity method are similar to the consolidation procedures described in IFRS 10” (IAS 28.26). In this regard, IFRS 10 sets out three requirements regarding key consolidation procedures: “a) line-by-line consolidation, b) elimination of the cost of the investment and c) elimination of intragroup transactions in full” (IFRS 10. B86). It is obvious that IFRS 10 provides very short and vague guidelines for the application of equity method requiring the elimination of intragroup transactions in full, because there is only one general request.

Three problems arise from this requirement (c) of IFRS 10 in the field of applying the equity method (Bradbury, 2018). The *first problem* relates to the fact that IFRS 10 considers that the group consists of parent and subsidiary companies, so associates and joint ventures are not part of group. Viewed from that angle, there are no intragroup transactions between investors and associates, so the question arises whether internal results should be eliminated. The *second problem* relates to the dilemma of whether the significant influence of investors generally imposes the need to eliminate internal results. In that sense, the investor has significant influence, but not control, so the question is whether he has information at all for the purposes of eliminating internal results. There are several practical questions that arise related to this problem. First, what about normal transactions that take place under market conditions and at fair value? Although we are talking about transactions between related parties, the question here is: is any internal profit unrealized? On the other hand, if the transaction was not carried out under normal market circumstances (out of arm's reach), there are opinions that the investor should

---

<sup>3</sup> In this case, the carrying amount of investment is reduced to zero, while internal profit above the value of the investment should be recognized as a liability. This is in line with the requirement of loss accounting according to IAS 28.39 and this solution should be preferred. At the moment when internal inventory is sold, a reversal procedure will be implemented.

eliminate the entire amount of unrealized profit, and not just the part proportional to his interest in associate or joint venture (KPMG, 2019). In this regard, the *third problem* consists of the fact that the requirement of IFRS 10 for the complete elimination of intercompany transactions is contrary to the application of the equity method. If the investor owns inventory purchased from an associate, those inventories contain 100% of the internal profit from transaction, but the investor participates in the associate's profit only in proportion to its capital investment. Therefore, it is not obvious from the requirements of IFRS 10 what "elimination in full" means in the context of applying the equity method, i.e. whether 100% of the unrealized profit should be eliminated or only investor's proportion of that profit.

From the above, it can be concluded that the IFRS 10 guidelines do not offer assistance in the application of the equity method and even contradict it. In addition, IFRS 10 does not specify who should perform the elimination of the internal result, the investor or the investee. On the other hand, IAS 28 provides the following guideline for eliminating internal results in transactions between an investor and an associate or joint venture: "Gains and losses resulting from 'upstream' and 'downstream' transactions ... between an entity (including its consolidated subsidiaries) and its associate or joint venture are recognised in the entity's financial statements only to the extent of unrelated investors' interests in the associate or joint venture." (IAS 28.28). Therefore, only the investor's share in the associate's or joint venture's gains or losses resulting from these transactions need to be eliminated.

Although it is not clear from the requirements of IAS 28.26 and IFRS 10. B86 whether it is necessary to eliminate intercompany transactions between the investor and the associate (and in what way), paragraph IAS 28.28 provides a very specific request concerning that matter. However, this paragraph is in a certain sense incomplete and contains some ambiguities. In the first place, the question arises as to why a distinction is made between upstream and downstream transactions if the method of their elimination is the same. In addition, paragraph IAS 28.28 does not specify whether internal profit/loss should be eliminated from inventory or from the income statement of the entity in which it is contained. This is followed by the question of whether downstream and upstream transactions should have the same treatment when eliminating internal results. Eliminating the internal result by simultaneously correcting the value of the investment and the income of the entity that is the seller in the transaction is considered a traditional approach, that is almost universally accepted in practice, although adjusting the value of inventory of the buyer is also an acceptable option (Hoyle, 2011).<sup>4</sup> In this regard, some authors believe that when eliminating internal results from upstream transactions, adjusting the investor's inventory is a more appropriate option than adjusting the income of the associate (adjusting of investment should be done in every case) (Krimpman, 2015; Bradbury, 2018). This is related to the question of whether the investor, through his significant influence, can influence the prices of upstream transactions and whether he can know the cost structures and the internal result of the investee.

Finally, the logical extension to the approach of proportional elimination of internal results implies the proportional consolidation of the assets and liabilities of the associate, and not only the consolidation of the proportional part of the net assets. This kind of

---

<sup>4</sup> Here we can add the previously mentioned dilemmas about whether the internal results should be eliminated at all when the transaction was carried out under market conditions, and if they should be eliminated, whether to do it completely or only proportionally to the investor's participation.



equity accounting (one-line consolidation) is also considered one of the shortcomings of the equity method, but it goes beyond the topic and scope of this paper. Given the aforementioned open questions and dilemmas, the IASB should expand the scope of its equity accounting projects to address these issues. In the first place, the IASB should clarify whether associates are part of a group. If they are, then the procedures for eliminating internal results would be justified, but, on the other hand, if the associates are not part of the group, then it would be necessary to consider whether the significant influence of the investor is a sufficient basis for eliminating internal results, because internal transactions could be arms-length. Also, if it is necessary to eliminate internal results, there is a need to specify the way to achieve it - using proportional or full elimination and answering the question whether upstream and downstream transactions should have the same treatment or not.

#### 4. ELIMINATION OF INTERNAL RESULTS WHEN PARENT USES EQUITY METHOD

The area of application of the equity method expands in situations where the parent company does not prepare consolidated financial statements, but "parent only", i.e. separate financial statements, or when a subsidiary company is exempt from consolidation. In such cases, the parent company can use the equity method and implement the one-line consolidation procedure (Chasteen, 2002). When the parent company applies the equity method, the procedure for eliminating intra-company transactions and results will differ to a certain extent compared to situations when the parent prepares consolidated financial statements or when investor/investee relationship exists (when the "common" version of the equity method is applied). The differences in the elimination of unrealized profits/losses in ending inventory compared to full consolidation or one-line consolidation with significant investor influence are determined by:

- direction of intercompany sales (downstream or upstream)
- percentage ownership in subsidiary

Basically, the specifics of eliminating internal results when the parent company uses the equity method arise from the treatment of non-controlling interest. If there were no minority shareholders (100 percent owned subsidiaries), the internal results would be eliminated in the same way as during full consolidation (elimination in full) or during one-line consolidation (proportionally to the investor's participation) (Beams et al., 2018). Also, while the direction of the transaction (downstream or upstream) does not affect the elimination of internal results neither during full consolidation nor during one-line consolidation, when the accounting company applies the equity method, it will be done in a different way for upstream and downstream transactions.

In this regard, during the consolidation process, parent eliminates any unrealized profit/loss from ending inventory in its entirety, for both upstream and downstream sales. However, during the upstream transactions, the non-controlling interest share can be affected since the subsidiary's separate income contains unrealized profit/loss. On the other hand, during downstream sales, unrealized profit/loss is included in the separate net result of the parent company, which does not affect a noncontrolling interest share because noncontrolling shareholders have an interest only in the profit of the subsidiary. Therefore, in upstream situations, when the subsidiary's separate income includes unrealized profit, during consolidation it should be reduced by the amount of unrealized profit related to minority shareholders. More precisely, when the parent company applies

the equity method, unrealized gains/losses on upstream transactions are eliminated proportionally between the controlling and noncontrolling interests. It is essentially the correct option, because both controlling and noncontrolling share of consolidated result are computed on the basis of the realized result from the viewpoint of the group. On the contrary, during downstream transactions, the parent that is applying the equity method eliminates 100% of the internal result, and not only the part that is proportional to its interest in the subsidiary (as in the case of upstream sales), because in such situations minority shareholders have no interest in the result of the parent company.

It should be said that US GAAP is not completely clear on the treatment of internal results during full consolidation, which can lead to inconsistent practice when there are noncontrolling interests. ASC 810 initially requires that “all internal gains and losses be eliminated completely, regardless of the direction of the transaction and the existence of a noncontrolling interest, which is in the spirit of the idea that consolidated financial statements represent the financial position and results of the group’s operations” as a single economic entity. However, the same standard further provides “the option that the elimination of intercompany profit or loss may be allocated proportionately between the parent and noncontrolling interest”. This possibility indicates that alternative approaches are available in eliminating internal results and computing the noncontrolling interest’s share of net income of subsidiary (Hoyle, 2011). The option that the elimination of internal results can be done completely or proportionally can result in an inconsistent treatment of internal results in terms of upstream transactions, both between the parent companies that perform full consolidation, and between consolidation procedures and equity method accounting. Regardless of the previously mentioned option, when the parent company uses the equity method for its separate financial statements, it will eliminate the entire amount of unrealized profits/losses during downstream sales, and only a proportional part during upstream transactions.

*Example:* To illustrate, assume that company A owns 80 percent of voting stock of company B. During the period, intercompany sales of 100,000 occur at a profit of 30,000. At the end of the year, inventory includes half of merchandise from the intercompany transactions. Company A does not prepare consolidated, but only separate financial statements, using equity method.

#### *Downstream sales*

Sales by a parent company to its subsidiaries increase parent’s profit but they do not affect the income of subsidiary until the goods are sold to third parties. Given that the entire amount of internal profit, which is contained in the inventory of company B, increases the profit of the parent company A, entire amount also must be eliminated from the parent income statement. The amount that must be eliminated is 15,000 ( $30,000/2$ ) because half of the internally transferred goods are still in stock. Under the equity method of accounting, elimination of this internal profit of 15,000 is done by reducing the value of its investment and the investment income of company A.

#### *Upstream sales*

Sales by subsidiary to its parent company increase parent’s profit but they do not affect the income of parent until the goods are sold to third parties. However, company A recognizes its share of income of company B on a proportional basis, so given that company B is partially owned subsidiary, only proportionate share of subsidiary’s internal profit will be deferred (80%). The amount that must be eliminated is 12,000 ( $15,000*80%$ ) and it will be done by simultaneously reducing investment and investment income of company A.

### CONCLUSION

Eliminating intragroup transactions and unrealized results that arise during them is the main prerequisite for presenting the financial position and success of the group as an economic entity through consolidated financial statements. The paper shows that the procedures for eliminating internal results can be very complex and accompanied by certain doubts and problems. The reason for this is the different nature of the relationships between the related parties within the group, as well as the vagueness of the accounting regulation in that area.

The application of the equity method, followed by the one-line consolidation procedure, implies that an investor with significant influence or joint control eliminates only part of the internal profits or losses in proportion to his ownership share. In that case, internal results derived from downstream and upstream transactions have the same treatment during their elimination. However, in situations where the parent company, which presents only separate financial statements, applies the equity method, the elimination of internal results will depend on the direction of the transaction. Then, during downstream transactions, 100 percent of the internal result will be eliminated, while during upstream transactions, only the proportional part corresponding to percentage ownership will be eliminated.

Equity method of accounting for intercompany transactions is often the subject of criticism in the scientific and professional public, which is, among other things, caused by the fact that the IAS 28 guidelines on this matter are not sufficiently clear and harmonized with IFRS 10. The most common doubts in this field refer to whether unrealized results should be eliminated at all if internal transactions between the investor and the investee are arms-length, then whether to eliminate complete or only a proportional part of the internal result, as well as whether upstream and downstream transactions should have the same treatment on that occasion. The vagueness of the accounting regulation opens up space for alternative procedures for eliminating internal results, which leads to inconsistencies in accounting practice. Therefore, the leading accounting regulatory bodies in the world (IASB and FASB) should make additional efforts in order to further clarify the procedures related to the treatment of intercompany transactions, both in the area of full consolidation and in the area of one-line consolidation procedures.

The lack of empirical research can be considered as the main limitation of this paper. However, we believe that our discussions can contribute to both the academic public and the accounting profession, as the focus on eliminating unrealized results from intra-group transactions has been neglected recently. Future research should certainly also provide empirical evidence using a sufficiently selected sample and suitable statistical methods.

### REFERENCES

- Abad, C., Laffarga, J., Garcia-Borbolla, A., Larran, M., Pinero, J. M., & Garrod, N. (2000). An evaluation of the value relevance of consolidated versus unconsolidated accounting information: Evidence from quoted Spanish firms. *Journal of International Financial Management & Accounting*, 11(3), 156-177. <https://doi.org/10.1111/1467-646X.00060>
- Aceituno, F., Valeriano, J., Bolivar, R., & Pedro, M. (2006). The conceptual framework concept and the allocation of incomes in the consolidated entity: Its impact on financial ratios. *International Journal of Commerce and Management*, 16(2), 95-115. <https://doi.org/10.1108/10569210680000210>
- Amel-Zadeh, A., Glaum, M., & Sellhorn, T. (2023). Empirical Goodwill Research: Insights, Issues, and Implications for Standard Setting and Future Research. *European Accounting Review*, 32(2), 415-446. <https://doi.org/10.1080/09638180.2021.1983854>

- André, P., Filip, A., & Paugam, L. (2016). Examining the patterns of goodwill impairments in Europe and the US. *Accounting in Europe*, 13(3), 329-352. <https://doi.org/10.1080/17449480.2016.1260748>
- Barker, R., Lennard, A., Penman, S., & Teixeira, A. (2022). Accounting for intangible assets: suggested solutions. *Accounting and Business Research*, 52(6), 601-630. <https://doi.org/10.1080/00014788.2021.1938963>
- Beams, F. A., Anthony, J. H., Bettinghaus, B., & Smith, K. A. (2018). *Advanced Accounting* (13th Edition). Pearson Education Limited, UK.
- Beck, A. K., Behn, B. K., Lionzo, A., & Rossignoli, F. (2017). Firm equity investment decisions and US GAAP and IFRS consolidation control guidelines: an empirical analysis. *Journal of International Accounting Research*, 16(1), 37-57. <https://doi.org/10.2308/jiar-51657>
- Bedford, A., Bugeja, M., & Ma, N. (2022). The impact of IFRS 10 on consolidated financial reporting. *Accounting and Finance*, 62(1), 101-141. <https://doi.org/10.1111/acfi.12782>
- Ben-Shahar, D., Sulganik, E., & Tsang, D. (2016). Does IFRS 10 on Consolidated Financial Statements Abandon Accepted Economic Principles. *Australian Accounting Review*, 26(4), 341-345. <https://doi.org/10.1111/auar.12135>
- Borowiec, L., Kacprzak, M., & Król, A. (2023). Information Value of Individual and Consolidated Financial Statements for Indicative Liquidity Assessment of Polish Energy Groups in 2018–2021. *Energies*, 16(9), 3670. <http://dx.doi.org/10.3390/en16093670>
- Bradbury, M. E. (2018). Commentary on the Adjustments Required for Intercompany Transactions when Equity Accounting Under IAS 28. *Australian Accounting Review*, 28(1), 140-147. <https://doi.org/10.1111/auar.12180>
- Brown, N. C., Huffman, A. A., Cohen, S. (2023). Accounting Reporting Complexity and Non-GAAP Earnings Disclosure. *The Accounting Review*, 98(6), 37-71. <https://doi.org/10.2308/TAR-2018-0760>
- Chasteen, G. L. (2002). Equity Method Accounting and Intercompany Transactions. *Issues in Accounting Education*, 17(2), 185-196. <https://doi.org/10.2308/iace.2002.17.2.185>
- Chasteen, L. G. (2005). Teaching variable interest entities under FIN 46: Untangling risks, expected losses, and expected residual returns. *Journal of Accounting Education*, 23(1), 47-66. <https://doi.org/10.1016/j.jaccedu.2005.02.001>
- Churyk, N. T., & Stenka, R. (2014). Accounting for complex investment transactions. *Journal of Accounting Education*, 32(4), 58-70. <https://doi.org/10.1016/j.jaccedu.2014.08.001>
- FASB (n/d). *ASC 810 Consolidation*. Available on: <https://asc.fasb.org/810/tableOfContent>
- Guillaume, O., & Pierre, D. (2016). The Convergence of U.S. GAAP with IFRS: A Comparative Analysis of Principles-based and Rules-based Accounting Standards. *Scholedge International Journal of Business Policy & Governance*, 3(5), 63-72. <http://dx.doi.org/10.19085/journal.sjibpg030501>
- Hevas, D. L., Karathanassis, G., & Iriotis, N. (2000). An empirical examination of the value relevance of consolidated earnings figures under a cost of acquisition regime. *Applied Financial Economics*, 10(6), 645-653. <https://doi.org/10.1080/096031000437999>
- Hoyle, J. B., Schaefer, T. F., & Doupnik, T. S. (2011). *Advanced Accounting*, (10th Ed.). New York: McGraw-Hill/Irwin.
- Hsiao, D., & Han, L. (2021). Give One a Fish or Teach One to Fish: An Exploration on Intra-Entity Transfers. *Journal of Applied Business and Economics*, 23(6), 1-9. <https://doi.org/10.33423/jabe.v23i6.4645>
- Hsu, A. W., Duh, R., & Cheng, K. (2012). Does the control-based approach to consolidated statements better reflect market value than the ownership-based approach?. *The International Journal of Accounting*, 47(2), 198-225. <https://doi.org/10.1016/j.intacc.2012.03.003>
- IASB (1996). *IAS 12 Income Taxes*. London: IFRS Foundation
- IASB (2011). *IAS 28 – Investments in associates and joint arrangements*. London: IFRS Foundation
- IASB (2011). *IFRS 10 Consolidated Financial Statements*. London: IFRS Foundation
- Just, R., Honold, D., & Meckl, R. (2023). Value relevance of goodwill accounting – how a forward-looking valuation approach guides goodwill recoverability. *Cogent Business & Management*, 10(3). <https://doi.org/10.1080/23311975.2023.2262213>
- Karmańska, A., & Wiśniewska, D. (2020). The concept of a ratio analysis of consolidated financial statements applied to listed capital groups on the example of the Deutsche Börse Group. *The Theoretical Journal of Accounting (Zeszyty Teoretyczne Rachunkowości)*, 110(166), 155-160. <http://dx.doi.org/10.5604/01.3001.0014.5555>
- KPMG (2019). *Equity method of accounting, Handbook*. Retrieved from: <https://frv.kpmg.us/reference-library/2022/handbook-equity-method-of-accounting.html>
- Krimpmann, A. (2015). *Principles of Group Accounting under IFRS*. John Wiley & Sons Ltd.
- Li, K. K., & Sloan, R. G. (2017). Has goodwill accounting gone bad?. *Review of Accounting Studies*, 22, 964-1003. <https://doi.org/10.1007/s11142-017-9401-7>
- Lopes, A. I., Lourenço, I. C., Soliman, M. T., & Branco, M. C. (2021). Is the relation between non-controlling interests and parent companies misleading?. *Australian Journal of Management*, 46(1), 24-50. <https://doi.org/10.1177/0312896219896388>

- Lopes, A. I., Lourenço, I., & Soliman, M. (2013). Do alternative methods of reporting non-controlling interests really matter?. *Australian Journal of Management*, 38(1), 7-30. <https://doi.org/10.1177/0312896212458788>
- Murphy, E. A., & McCarthy, M. A. (2010). Teaching Consolidations Accounting: An Approach To Easing The Challenge. *American Journal of Business Education (AJBE)*, 3(11), 101-110. <https://doi.org/10.19030/ajbe.v3i11.68>
- Needles, Jr., B. E., Powers, M., & Crosson, S. V. (2011). *Principles of Accounting* (11<sup>th</sup> Ed.). Mason, OH: Cengage Learning.
- Peng, S., & van der Laan Smith, J. (2010). Chinese GAAP and IFRS: An analysis of the convergence process. *Journal of International Accounting, Auditing and Taxation*, 19(1), 16-34. <https://doi.org/10.1016/j.intaccudtax.2009.12.002>
- Škarić-Jovanović, K. (2014). Uticaj primene metode udela na performanse investitora [Impact of the equity method's application on investor's performances]. *Acta economica*, XII/20, 59-75.
- Skinner, D. J. (2008). Accounting for intangibles – a critical review of policy recommendations. *Accounting & Business Research*, 38(3), 191-204. <https://doi.org/10.1080/00014788.2008.966332>
- Sotti, F. (2017). The role of non-controlling interests in the value relevance of consolidated financial statements. *Corporate Ownership & Control*, 15(1-2), 435-443. <https://doi.org/10.22495/cocv15i1c2p12>
- Srinivasan, P., & Narasimhan, M. S. (2012). The value relevance of consolidated financial statements in an emerging market: The case of India. *Asian Review of Accounting*, 20(1), 58-73. <https://doi.org/10.1108/13217341211224727>
- Su, W. H., & Wells, P. (2018). Acquisition premiums and the recognition of identifiable intangible assets in business combinations pre- and post-IFRS adoption. *Accounting Research Journal*, 31(2), 135-156. <https://doi.org/10.1108/ARJ-10-2015-0124>
- Tunyi, A. A., Ehalaiye, D., Gyapong, E., & Ntim, C. G. (2020). The value of discretion in Africa: Evidence from acquired intangible assets under IFRS 3. *The International Journal of Accounting*, 55(2), 050008. <https://doi.org/10.1142/s1094406020500080>
- van Hoepen, M. A. (1981). Deferred-tax accounting in group accounts. In: *Anticipated and Deferred Corporate Income Tax in Companies' Financial Statements* (pp. 168-199). Dordrecht: Springer. [https://doi.org/10.1007/978-94-017-4350-1\\_11](https://doi.org/10.1007/978-94-017-4350-1_11)
- Welc, J. (2017). Impact of Non-Controlling Interests on Reliability of Consolidated Income Statement and Consolidated Balance Sheet. *American Journal of Business, Economics and Management*, 5(5), 51-57. Retrieved from: <http://www.openscienceonline.com/journal/archive2?journalId=709&paperId=3773>

## NEKI IZAZOVI U KONSOLIDACIJI NEREALIZOVANIH UNUTARGRUPNIH DOBITAKA I GUBITAKA

*Procedure eliminisanja internih rezultata u praksi mogu da variraju zbog različite prirode odnosa između povezanih strana, ali i zbog nedorečenosti računovodstvene regulative koja otvara prostor za alternativne postupke u praksi. Načini eliminisanja internih dobitaka i gubitaka se pre svega razlikuju u zavisnosti od toga da li je reč o punom konsolidovanju finansijskih izveštaja ili one-line konsolidaciji, praćenju primenom metode udela. Pri tom, kod oba pomenuta postupka konsolidovanja otvaraju se pitanja vezana za to da li downstream i upstream transakcije treba da imaju jednak tretman, odnosno da li treba eliminisati ukupan interni rezultat ili samo njegov deo koji je proporcionalan vlasničkom učešću. Cilj rada se sastoji u analizi ovih specifičnih pitanja eliminisanja internih rezultata, uz razmatranje trenutnog stanja i mogućnosti unapređenja računovodstvene regulative na tom polju.*

*Ključne reči: konsolidovani finansijski izveštaji, separadni finansijski izveštaji, one-line konsolidacija, unutargrupne transakcije, interni rezultati, metoda udela.*