Internal Revenue Service
Market Segment Specialization Program

Garment Manufacturers

Audit Technique Guide (ATG)

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Garment Manufacturers

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Chapter 1

INTRODUCTION

NATURE OF THE INFORMATION IN THIS GUIDE

The purpose of this Market Segment Specialization Program (MSSP) guide is to provide the examiner with general and technical background information and to recommend specific audit techniques to make future examinations of garment manufacturers more efficient and effective. Though some aspects of the exam will be no different than procedures and techniques used for other businesses, there are many other areas where industry information and specialized audit techniques can make a substantial difference in the final result of the examination.

This guide is designed to supplement, not replace, an examiner's audit skills. It is not intended that an examiner locate and develop garment manufacturer issues without normal auditing procedures.

Most of the information compiled in this guide resulted from the examination of garment manufacturers' returns examined by the Research and Development (R&D) Group in the Los Angeles District between January 1987 and December 1993. Input was also solicited from the Garment Industry Project Team in the Dallas District as well as the Garment Group in the Manhattan District. Most of the entities that were examined specialized in the manufacture of ladies apparel, by far the largest segment of the industry. The quality of the merchandise manufactured by these entities ranged from budget clothing to top designer fashions.

At this point, a very important distinction should be made. This guide only deals with garment manufacturers, as opposed to garment contractors or retailers. A garment manufacturer is an entity that designs the garment, procures fabric and materials, coordinates all aspects of the construction of the garment, and sells the finished product to retailers. Some manufacturers do their own cutting, sewing and other operations needed to assemble a particular garment, but most "contract out" these production steps to independent contractors that perform specific steps in the manufacturing process, for example, dyeing, cutting, sewing. If you are examining a garment contractor, refer to the Garment Contractors MSSP guide (3147-105).

This guide does not address garment manufacturer returns in a line by line review, but rather highlights areas of the examination that are unique to the industry or that typically generate significant issues. The fact that a particular item or issue is addressed in this package does not necessarily mean that it contains automatic adjustments. What it does mean is that the information provided may shorten the audit time otherwise required to consider a particular area.

RESULTS OF THE EXAMINATIONS CONDUCTED

The issues that were the source of the adjustments varied widely. This emphasizes the fact that the examiner must be open to and aware of a number of areas that have adjustment potential.

Though some of these areas will be addressed in detail later in this package, the following are examples of adjustments that were made:

1. Inventory.
2. Write downs, costing errors, omissions, uniform capitalization.
3. Purchases -- improper accruals.
4. Shareholder Loans.
5. Inputed interest under IRC section 7872, loan write-offs against salary payable that is not included in Form W-2 income.
6. Related Party Transactions.
7. Sales of assets, excess payments to related contractors, management fees, consulting fees, unreported income received from a related party.
8. Relief of Liability Income.
9. Acquired Net Operating Loss.
10. IRC section 269.
11. Disallowance of Entertainment Facilities.
12. Condominiums, boats, country clubs etc.
13. Unallowable Accruals/Reserves for Sales Discounts and Returns and Allowances.
14. Travel and Entertainment; IRC section 162 and/or 274.
15. Trips abroad, excessive auto deductions, restaurants, payments of various personal expenses.
16. Auto Expenses and Depreciation.
17. Commissions.

18. Unreported by shareholders or employees, particularly when no Forms 1099 are issued.

19. Legal Fees.

20. Nondeductible, capitalized.

21. Bad Debt Disallowance.

22. Life Insurance.

23. Shareholders, key employees.

24. Pick-up of Related Shareholder Returns.

25. For issues related and unrelated to manufacturer's return.

26. Employment Tax Adjustments.

27. Independent contractors versus employee issues, bonuses to employees, other payments to employees constituting "wages," back-up withholding.

28. Form 1099 Penalties.

29. Failure to file, incorrect ID number of recipient on the Form 1099.

Examiners are sometimes contacted by individuals who offer information of sales "off the books," and these leads are always evaluated as potential audit leads.

SPIN-OFF RETURNS

A significant portion of the total deficiencies generated by an examination of a garment manufacturer may be attributable to "spin-off" returns. These are returns that, if not for the examination of the manufacturer, may never have been audited. Given the frequency with which these returns were found to contain significant adjustments, take more than a quick glance at any returns provided for inspection as part of the Required Filing Checks. In addition, returns provided for inspection purposes should be referred to at various points of the examination for consideration of audit potential.

What follows is a brief discussion of the most common types of spin-off returns.

Officers and Shareholders

The principals of a company may often have significant transactions with the corporation that are not at arm's length. Consequently, issues such as the sale of stock, travel and entertainment, auto expenses, unreported reimbursements, and life insurance may yield large dollar deficiencies at both the individual and corporate level. Moreover, there may be other issues on their individual returns that bear no direct relationship to the manufacturer being examined but which nonetheless have audit potential (that is, investment losses, rental property, sales of assets, miscellaneous business expenses, Schedule C businesses, etc.)

Related Entities

It is not uncommon for individuals to own interests in more than one garment manufacturing company. Sometimes these entities will have intercompany transactions or similar issues that require the examiner to open another examination.

Contractors

A significant number of contractor returns have been spun off examinations of manufacturer's return, as potential unreported income cases. These unreported income cases can be developed using the canceled checks of the manufacturer under examination. Guided by the endorsement information on the back of the canceled checks, contractor cases can be developed using the specific-item method for identifying unreported income. Civil or criminal fraud penalties may be applicable and should be considered.

Employees and Agents

As with many examinations, there may be employees or agents who may receive special "perks" and payments. Particular attention should be paid to their dealings with the company to assure that personal expenses are not being paid on their behalf as a nontaxable form of compensation. It may be necessary to inspect certain employees' returns based on information obtained from the business books and records, observations, and inquiries. RTVUE facsimiles of returns may provide enough detail to confirm whether an exam is warranted; if not, the returns will have to be requisitioned under normal procedures. If a comparison of all relevant information obtained through the audit of the business return is inconsistent with income and expenses claimed on an employee's return, an audit of that Form 1040 should be considered.

Employment Tax Case

A manufacturer may allow various shareholders or employees to reap benefits or receive payments that constitute "wages" under the employment tax rules and regulations, yet omit these amounts from employment tax and information returns. Examples of issues that generated the spin-off of an employment tax case include cash bonuses that are not paid through payroll, reimbursements of personal expenses (that is, autos, insurance, etc.), and bargain sales or free-of-charge transfers of assets such as cars.

In addition, independent contractor versus employee issues should always be considered for those receiving consulting fees, professional fees or similar type payments, particularly when the individual receiving such payments is also an employee or former employee of the manufacturer. It should be noted that garment contractors (sewers, cutters, markers and graders) are normally considered true independent contractors under the 20 common law factors. Similarly, manufacturers' representatives are also treated as non-employees in most situations, especially if they handle the lines of several manufacturers simultaneously.

Non-corporate contractors that are paid without first providing their taxpayer identification numbers to the manufacturer require the manufacturer to backup withhold 31 percent of each payment (IRC section 3406). Amounts withheld are reportable on Form 941, so back-up withholding adjustments are part of an employment tax case file. A separate section contains a more complete discussion of back-up withholding.

Information Return Penalties

When manufacturers neglect to file Forms W-2 or 1099 or file them with inaccurate or incomplete information, a penalty case may be warranted. A separate section contains a more complete discussion of information return penalties.

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Chapter 2

NATURE OF THE BUSINESS

OVERVIEW

[This is a simplified, generic description of a manufacturer's operations. Its purpose is only to convey a sense of the variety and chronology of activities that take place within a manufacturer's business.]

Garment manufacturers employ a variety of people to produce garments that can be sold to retailers for a profit. (See Exhibit 2-1 for a simplified model of Garment Industry Production.) Most manufacturers are not huge corporations or conglomerates but rather small to medium sized closely held companies. Regardless of size or form, most manufacturers are organized into the following departments:

1. Design

2. Sales

3. Production

4. Receiving and Shipping

5. Accounting and Administration

Design

Garments are conceived in the design department, but there is no smooth, uninterrupted flow from a designer's sketch through to a production run. As a matter of fact, only a fraction of styles considered by a design department are actually manufactured in production quantities. Some are dropped after preliminary sketches, some are eliminated after a sample is sewn, and yet others are taken out of a line after salespersons start showing it.

The blueprint for a garment's construction is a "pattern." Once the pattern is finished, a "sample" can be made; samples are prototypes that allow experimentation with design alternatives, fabrics, fabric designs and colors. Viable styles are then "costed" to estimate the cost per dozen or per unit to produce that particular style. A wholesale price is determined and the sales force begins showing the lines and taking orders from retailers. Most garments are produced on a "cut-to-order" basis, as opposed to being made for inventory in anticipation of orders. The latter is generally too risky a proposition unless initial orders indicate an especially "hot" item.

Sales

Salespersons show lines and solicit orders. While some manufacturers rely solely on employee salespersons, others use only manufacturer's representatives who are independent contractors. Still other manufacturers have a sales force that is a combination of the two.

Los Angeles manufacturers commonly lease showroom space in Los Angeles and in New York City. They would have employees working at these sites, as well as in any other cities in which they lease a showroom. Manufacturers' lines may also be shown at showrooms leased by independent manufacturer's representatives, but the manufacturer is not the lessee in these situations.

While smaller (in sales volumes) customers travel to view a manufacturer's lines, major customers often have separate showings at the customer's facility.

If enough orders for specific styles are received at or near the listed wholesale price, the manufacturer begins the production of those styles.

Production

Generally, the manufacturer subcontracts production labor, (that is, marker making, grading patterns for different sizes, cutting the material and sewing the garment into a finished product.) Occasionally a manufacturer will do some or all of its own cutting or sewing work, but this is the exception, not the rule.

If a contractor's quick response is of primary importance, a manufacturer will use contractors within the same geographical area as the manufacturer. Otherwise, contractors who are located far from the manufacturer may be good options. Many Los Angeles manufacturers use Mexican contractors under the Maquiladora (also known as the 807) program to take advantage of much lower labor costs in Mexico. Cut goods are transported to the Mexican contractor, whose own employees assemble the garment. The finished goods are shipped back to the United States for distribution to the manufacturer's customers. If a significant portion of a manufacturer's production is in Maquiladoras, particularly if there is an ownership relation with the manufacturer, the examiner may want to involve an international examiner in the audit. As an alternative, the examiner can address pertinent issues after consulting with the Maquiladora ISP, located in the South Texas District.

Another variation involves the use of "CMT contractors" (cut, make, trim), in which the manufacturer provides the design and all specifications of the garment. He contracts for a completed garment; the contractor assembles all of the necessary fabric, trim, findings, and labor to produce the finished goods. There are domestic CMT contractors, but the far greater volume is from CMT contractors in Asia, Southeast Asia, and India and vicinity.

Because so much of a manufacturer's production is actually performed by other parties, the production department's functions are more correctly characterized as scheduling and monitoring. After determining which contractors will be assigned what work, production personnel ensure that the contractors are provided with the cut goods on time (except for CMT contractors), that the work is meeting prescribed quality standards, and that the finished goods are returned to the manufacturer timely.

Accounting and Administration

Included in this category are accounting, customer service, computer services, personnel, payroll, and executive management.

SEASONS

A manufacturer can have as few as two seasons or as many as five, depending on the type of clothing manufactured and the size of the operation. Generally, the larger and more diversified the product line, the more seasons produced. Spring and Fall are the two reasons almost every manufacturer will produce. In addition, a manufacturer may have up to three other seasons. A full complement of five seasons would be, in chronological order: Spring, Summer, Fall, Resort (a.k.a. Holiday, Cruise), and Winter.

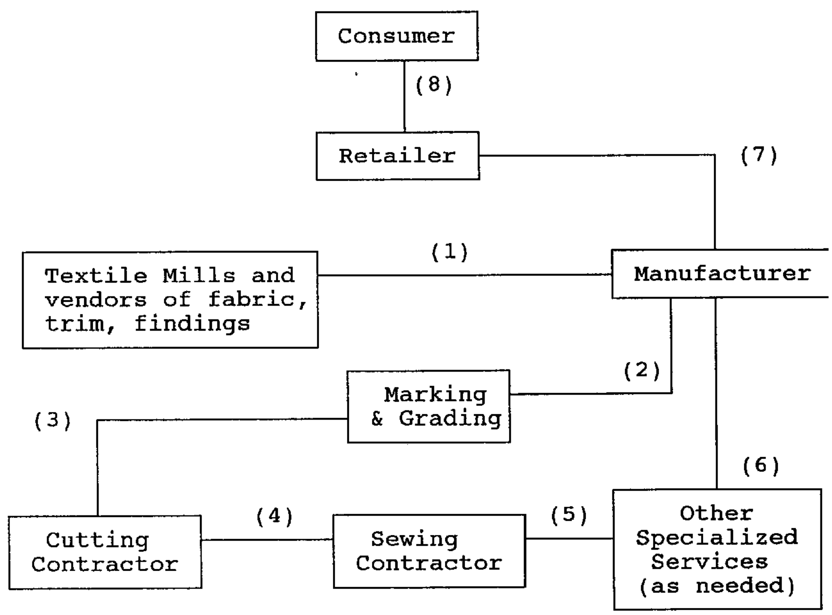
FACTORING ACCOUNTS

Most manufacturers "factor" their accounts receivable. Customers whose receivables are factored pay the factor, who in turn remits the money (less certain fees) to the manufacturer. Factors in the garment industry customarily buy receivables without recourse as to credit risk, meaning that the factor assumes full risk if the customer's financial condition prevents full payment. Factors do not accept shipping risk . The factor purchases receivables of approved customers. Sales to customers not approved by the factor, or sales over dollar limits set by the factor, are at the manufacturer's risk.

Factoring is an important cash flow consideration in the garment industry. The factor advances cash to the manufacturer based on outstanding factored receivables. In exchange for its service, the factor charges a commission of approximately 1 percent of the net receivables factored. In addition, the factor charges interest on the amounts advanced during the month. Any commission and interest charged is shown on the factor's monthly statement and deducted directly from the amount that is available for remittance to the manufacturer.

Also shown on the factor's monthly statement are"charge backs." Any time the retailer disputes the manufacturer's invoice, whether it be for returns, allowances for damages, incorrect, late or short shipments or special discounts, the factor will charge it back to the manufacturer and let the manufacturer and the retailer resolve the matter. The manufacturer maintains a journal to account for each charge back, often referred to in the industry as a "charge back journal."

Garment Industry Production
(Simplified Model)



<u>Industry Process</u>

(1) Manufacturer purchases fabric, trim and findings.

(2) Patterns are graded to size and a marker is made.

(3) Fabric not cut by manufacturer is cut by a cutting contractor.

(4) Cut fabric is transferred to sewing contractor and is sewn into various garments.

(5) Other specialized services, if needed.

(6) Finished goods transferred back to manufacturer.

(7) Goods are delivered to retailers.

(8) Goods are sold to consumers.

Chapter 3

FACTORY VISIT AND INITIAL INTERVIEW

FACTORY VISIT

As previously noted, most garment manufacturers in the Los Angeles area contract out all or most of their marking and grading, cutting and sewing work. A visit to their facility, therefore, will usually not give the examiner a complete picture of the manufacturing process. The facility will not be a factory in the common sense of the word because most of the production activity takes place elsewhere.

The typical garment manufacturer's facility consists of administrative offices, design rooms, sample maker's areas with a few sewing machines and usually a cutting room with long tables varying in size with the amount of in-house cutting done. The bulk of the available space will usually be occupied by storage facilities located close to a shipping and receiving area and the cutting room. Piece goods on bolts will be stacked on pallets and shelves. Devices to measure and inspect incoming goods will be in the same area. When outside cutters are used, a portion of the piece goods inventory may also be stored on the contractor's premises.

The balance of the storage area will contain rack systems for finished goods storage and possibly a separate inspection area for finished goods coming in from their contractors. Rack systems vary, but are often bi-level or tri-level arrangements to conserve space. Garments on racks awaiting shipment to customers may be grouped by style, color, and size or by customer order awaiting completion prior to shipping.

There are some manufacturers that do their own cutting, sewing, and finishing with little dependency on outside contractors. A visit to such a factory will allow a more comprehensive view of the entire manufacturing process. The facilities will house additional cutting and sewing space and industrial pressing equipment. There may be a separate area for pattern makers, grading, marker making, and duplication. The sewing area will generally house both single needle and overlock machines, buttonhole and button sew machines, and possibly specialty machines such as cover stitch and embroidery machines if the manufacturer's line requires them. Only a portion of the entire sewing operation is done at each station and partially completed batches of garments are then moved to the next station in bundles or carts for completion of the next sewing operation.

A completed marker can be as long as 30 feet and cutting tables need to be at least long enough to accommodate the largest markers used by a manufacturer. In practice, they will often spread the fabric for two shorter markers on the same table. The number of tables and the size of the cutting area will vary with the size and needs of the manufacturer, but generally should provide enough space to allow, at least three markers to be spread, rest, or cut simultaneously.

Computerized equipment is widely available today for greater accuracy in design, cutting, and marker making and may be in use, as may be one of the newer conveyer systems for moving garment units through the sewing process. Because such equipment is still quite costly however, it is likely to be found only at larger manufacturer facilities, where the volume will be sufficient to fully utilize the capabilities of the machinery.

INITIAL INTERVIEW

The quality of your initial interview and your observation of the business premises will affect the overall success of the entire examination. The questions you ask should generally enable you to obtain the background of the taxpayer, to familiarize yourself with the operation of the business, to understand the accounting system and to fix responsibility for the records. You will also need to evaluate the positions held by the principals.

Planning is essential to ensure a successful interview. A good pro forma may be consulted as a guide in constructing a questionnaire or outline that covers basic information, but if used, it should be augmented to specifically relate to the business of the manufacturer under examination. Analysis of the return will undoubtedly produce questions unique to the particular business or year under examination that should be incorporated into your interview.

The acquisition of substantial new machinery and equipment might suggest a shift in operations. A number of luxury autos on the depreciation schedule could prompt specific questions about the use of the cars in the business and such events as ownership changes, theft losses, and asset sales would merit specific inquiry.

Since this is a manufacturing operation, question the taxpayer regarding the manner of production. Ask if goods are produced only after an order is received and if piece goods are purchased only as needed to fill orders or if they are stocked. Find out how long it takes to fill a retailer's purchase order and if there is any production done specifically for inventory. Inquire also about the disposition of excess inventory, overruns, and piece goods.

Find out what function the officers, shareholders and relatives have in the corporation. Officer salaries are often among the largest corporate expenses and may not be properly allocated for inventory purposes, or occasionally may be the subject of an excess compensation issue. Ask if shareholders or their relatives have dealings with the corporation as perhaps landlords, suppliers, contractors, or customers.

Some questions that you might wish to incorporate into your garment manufacturer interview follows. The listing includes only items relating to garment production, sales, and officer/shareholder duties. Questions about the corporate history, accounting methods, internal controls, and mandatory items should, of course, be added.

1. What type(s) of goods are manufactured? (for example, junior dresses, petite suits, or misses blouses)

2. What level of garments are made? (for example, budget, moderate, or better)

3. What labels are produced?

4. What is the wholesale price range for each line?

5. What is the usual markup from cost?

6. How many fashion seasons are produced a year? When does production begin and when does delivery commence?

7. Explain the main functions that take place in the design department.

8. Is production begun only after orders are received? If not what basis is used to determine the size of the first cut?

9. Are piece goods ordered prior to the receipt of orders? If so how are quantities determined?

10. Which manufacturing processes are contracted out? (for example, marking and grading, cutting and sewing) Is any work done on the premises? (for example, sample making or some cutting)

11. How long does it take to fill an order once it is taken? What is the usual turnaround promised to the customer?

12. What is the geographic area of distribution?

13. What types and sizes of stores handle the lines?

14. Is there a minimum order size?

15. Are any of the retailers related to the manufacturer or its shareholders?

16. What are the sales terms offered and do they vary with the customer? (for example, when is payment due, what allowance and/or discounts are offered?)

17. What percentage of sales are factored?

18. Describe the general procedure for researching a disputed charge back.

19. Are all disputed charge backs researched, or is there an amount below which a dispute is automatically written off?

20. What specific individual must approve writing off a dispute that is still unresolved after research?

21. What is the location of major suppliers? Are any purchases made from overseas suppliers and if so, how are payments made?

22. Is the manufacturer or its shareholders related to any supplier?

23. Where are your contractors located?

24. When a new, local contractor begins working for you, do you require him or her to provide you with a Form W-9? A registration certificate? Other documents? Where are those items filed?

25. How are the contractors paid?

26. How often are the contractors paid?

27. How soon after delivery of finished garments is payment made for the work?

28. Are the corporation or its shareholders related to any of the contractors?

29. Where are showrooms maintained? Are any other corporate facilities maintained apart from the factory site?

30. How are the following disposed of: Overruns? Seconds and damages? Returns? Excess piece goods?

31. Are the present officer/shareholders the incorporators?

32. What are the duties of the current shareholders?

33. What is the current percentage ownership of each shareholder?

34. Is there any family relationship between the shareholders?

35. Were relatives of the shareholders employed by the corporation?

36. How is officer compensation (salary, bonus, fringe benefits) determined?

37. Does any officer, relative, or group of which an officer is a member, have dealings with the corporation other than as an employee? (for example, lessor, vendor, consultant)

38. Does the corporation own or lease vehicles assigned for the use of specific officer/shareholders?

Chapter 4

DOCUMENTS AVAILABLE

INTRODUCTION

Garment manufacturers generate and receive thousands of documents annually in the course of dealings with suppliers, customers, and contractors and in the course of recording intra-company matters. The listing that follows describes the sorts of documents that should be available to the examiner, their content and utility. Individual manufacturers may develop additional documents designed to measure or correct some particular production or sales problem, combining the information included in some of the documents outlined to enhance their utility to management.

COST SHEETS

This is usually the first document generated for each style produced. It contains the initial estimates of costs for all phases of production and a total estimated cost for a particular style number. It includes the cost of piece goods and trim required, cutting and sewing labor, freight, overhead, and miscellaneous costs such as labels, hang tags, plastic bags, and hangers. The selling price will often be indicated as well, and a sketch or photograph of the garment is usually included. Once a design goes into production, the cost sheet is generally revised to reflect the actual costs incurred.

Cost sheets may be called "spec" sheets, "calc" sheets or some other such variation coined by the manufacturer, and cost sheets format varies.

The cost sheets can be used to verify the cost of the finished goods and work in process inventories, but since they often contain inaccuracies, the amounts on the cost sheets should be spot checked where possible. Piece goods purchase and contractor charge verification can be used for this purpose if piece goods and contractor charges close to year-end are sampled.

PURCHASE ORDERS

These documents, as generated by the manufacturer, offer a description of the fabric, color, and quantity ordered from a supplier as well as the expected cost. Trim orders will have similar specifications. They are of limited utility since invoiced price and quantity may vary, but may occasionally be presented as verification for a questioned cost.

Retailers will also generate purchase orders kept in the manufacturer's files. They will indicate the style number, quantity, and cost of the garments ordered and the expected delivery date. The terms of payment and discounts or allowances anticipated will often be printed on the purchase order.

PIECE GOODS AND TRIM INVOICES

These give a description of the fabric, color, and quantity purchased. The total cost of the invoiced items as well as the unit cost of each item is shown. Piece goods are usually billed in yards plus eighths of a yard, but may be billed by the pound, or in meters if imported. The shipping weight and freight charges may also appear on the invoice.

The invoices will be numbered and dated with the terms of payment stated. Terms for piece goods are generally net 60 days and payment for trim is usually expected within 30 days. Discounts based on interest rate are usually given for early payment of invoiced amount.

Several invoices from the same supplier are usually paid with one check and all of them will be filed stapled together with the related freight and delivery documents and any credit or debit memos generated by the manufacturer. The date of receipt of the shipment is often recorded on the invoice.

Invoices can be used to verify the cost of goods purchased during the year and in inventory, and to check the accuracy of cost sheets. Year-end deliveries should be accounted for in the ending inventory.

DELIVERY DOCUMENTS

These include shipping documents and bills of lading; packing lists describing the number of bolts, yards, and shipping weight; and delivery slips indicating the date of delivery. Receiving documents will contain data regarding the number of rolls, yards, and colors received and the receipt date if it has not already been stamped on the related invoice. The manufacturer's description of the goods received may differ from that shown on the supplier's invoice and should be noted for purposes of inventory identification. These documents are usually associated with the related purchase invoice.

Imports will generate statements from U.S. Customs and Customs brokers which may be associated with other documents but are usually filed separately. Freight bills are often included in the purchase invoice package, though these also may be filed elsewhere. Some freight is billed directly by the supplier. These documents can be useful in estimating per yard freight costs includible in inventory.

CREDIT MEMOS AND DEBIT MEMOS

Credit memos issued by the manufacturer usually cover shortages, returns, price variances, or damages of invoiced goods and are sometimes used to charge back all or part of freight charges. Copies are generally attached to the purchase invoice. Debit memos are sometimes issued to correct erroneous credit memos or acknowledge receipt of excess goods or an incorrect price. They may also be issued to customers to adjust a shipment price.

Credit memos are also issued by the retailer to the manufacturer to cover returns, shortages, or any kind of allowance claimed on a shipment of finished goods. Though a notation may be kept with the sales invoice, the document is generally submitted to the factor and filed with the monthly statement.

CUTTING TICKETS

This document identifies a specific cut and style number, and transmits goods to the cutter. The style number used is the same as that appearing on the cost sheets and refers to a specific design. The cut number may be a combination of date and number, (that is, 88-5-24) and could be used to designate the 24th batch sent out for cutting in May 1988. The ticket shows the amount of yardage to be cut and often the expected and actual yield by garment size.

The ticket may also transmit trim and identify the sewing contractor scheduled to receive the cut. More comprehensive cutting tickets will trace each cut through production to entry into finished goods inventory with the dates of movement of goods as well as the number of garments, first quality or damaged at each stage of production.

These documents can give a good indication of the length of the production cycle. Many production managers maintain a summary spreadsheet showing all cuts for a particular month and comparing the production data described above and possibly cost figures as well. If such a summary is maintained it is usually the source for the work in process inventory valuation.

CONTRACTOR INVOICES

Cutting and sewing contractors invoice manufacturers for work delivered by cut and style number at the negotiated cost. The manufacturer generally has a receiving document attached to the contractor's invoice which verifies or corrects the invoice. Several such invoices may be added to compute the weekly check issued.

Cost sheets and inventory valuation should reflect the same costs for cutting and sewing a specific style number as are shown on the invoices and payment records.

SALES INVOICES

Sales invoices are prepared by the manufacturer showing style number, size, quantity, color, and wholesale price of the garments shipped. The customer's purchase order number, date of shipment, carrier, and terms are also included. Factored sales will carry a notification to the buyer with instructions for direct payment. A bill of lading will accompany the shipment and a copy may be associated and filed with the invoice.

FACTOR STATEMENTS

Factor statements are issued monthly and are much like a bank statement. They list sales factored during the month, outstanding balances, and payments received. Reductions in the amount of the receivables are shown and are often coded with an explanation for the charge back with the customer's credit memo attached.

The statement shows the advances for the month, usually by transfer to the manufacturer's business checking account, and interest charges made on any advances.

INVENTORY RECORDS

The inventory is generally separated into three or four categories: piece goods, work in process, finished goods, and trim. Trim is sometimes omitted but may be included with piece goods.

The inventories contain a description of the piece goods, cut, and style number for work in process and styles of finished goods, plus a quantity and price for each item and an extension. Contracted work in process in cutting will include only the cost of piece goods and freight in. Contracted work in process at the sewing contractor will equal the cost of finished goods less sewing labor costs. If the manufacturer does not use contractors, half of the cutting labor will generally be added to cutting work in process and half of sewing labor will be included in sewing work in process.

A column may be included to show the amount by which an inventory item is marked down, alternatively markdowns may be taken directly with the stated price reflecting a reduced cost.

The inventories are then summarized and adjusted to reflect goods in transit where title has passed.

Further adjustment is then necessary to incorporate the IRC section 263A allocation, and these work papers should also be associated.

Inventory is discussed in more detail in Chapter 7, Cost of Goods Sold.

Chapter 5

BALANCE SHEET ACCOUNTS

INTRODUCTION

The purpose of this section is not to instruct the reader on how to do a balance sheet audit but rather to emphasize the importance of good balance sheet review when examining garment manufacturer returns. In many cases the unusual will not be identifiable on the face of the balance sheet. The line items selected for audit must be separated into their component accounts, then analyzed to see if they make both accounting and tax sense. This requires the examiner to use his or her judgment in deciding how much work, if any, will go into each balance sheet line item.

Often an adjustment that is difficult to identify in an income statement account, will be readily apparent upon a review of the related balance sheet accounts.

Example 1

Manufacturer XYZ shows a liability for sales discount reserves of $400,000 at the end of the 1992 calendar year, the year under examination. XYZ has a policy of allowing 2 percent discount if accounts are paid within 30 days after billing. Upon further inspection of the general ledger accounts, the following is discovered:

Sales Discount Reserve

12/31/92	5,000	

Sales Discount Reserve

	395,000	1/1/92
	5,000	12/31/92
	400,000	12/31/92

Sales Discount Expense 5,000
Sales Discount Reserve 5,000

To record sales discounts after computing pending year-end discounts of $400,000.

Discovery of such entries through a balance sheet review should be followed up with a request for additional records such as the accountant's work papers and support. If the examiner finds that the reserve represents an unallowable accrual under the "all events" and/or "economic performance" tests, a net adjustment of $400,000 would be warranted. (Note: The adjustment would be a Category A change of accounting method requiring an IRC section 481(a) adjustment.)

The example illustrates the point that if the agent looked solely at the expense account, only the $5,000 sales discount expense would have been observed. It is quite possible that such an amount would have been dismissed as "immaterial" and never examined further. The balance sheet, on the other hand, tells a completely different story. It tells the examiner that: 1) XYZ has a reserve account for sales discounts, 2) $5,000 was added to the reserve at year-end, and 3) $395,000 was reserved in tax year, prior to 1992. The $5,000 expense that appeared immaterial on the income statement is actually a $400,000 accrual issue. Again, if a thorough review of the balance sheet is not done, this large adjustment could easily be missed by the examining agent.

The balance sheet should always be reviewed in conjunction with Schedule M-1, which may explain an item that would otherwise be considered unusual for tax purposes. For instance, in the example above, the $400,000 reserve would not have been deducted for tax purposes if Manufacturer XYZ listed the $400,000 as an item "expensed on the books but not on the tax return." Under these circumstances, no adjustment to correct the reserve would be warranted.

Other areas on the balance sheet that have led to adjustments on garment manufacturers' returns include, but are not limited to, the following:

1. Loans To/From Shareholders

2. Other Loans

3. Relief of Liability

4. Fixed Assets

5. Related Party Sales, Entertainment Facilities

6. Inventory

7. Writedowns, Costing Errors, Omissions, Uniform Capitalization

8. Accrued Expense

9. Large Improper Purchase Accruals, Bonus Accrual, Other Unallowable Accruals

10. Intercompany Accounts

11. Unreported Income, Padded Expenses, Or Other Inconsistent Reporting

12. Capital Stock

13. Changes In Ownership, Improper Reporting of the Sale of Stock By the Shareholder

14. Bad Debt Expense

15. Improper or Premature Write-offs.

It is the examiner's responsibility to incorporate a thorough review of the balance sheet during the examination. This means not just looking at the balance sheet during the pre-audit but also during the examination, when the trial balance, general ledger, journals, and accountant's work papers allow for a more detailed analysis.

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Chapter 6

SALES AND RETURNS AND ALLOWANCES

SALES

A number of manufacturer principals and their accountants have related to examiners that "a person I know sells out the back door." This could mean casual sales to individuals (employees, relatives, friends, even the general public) or larger sales of goods to jobbers and small retailers. Some or all of these sales may not be booked as income. These anecdotes of unnamed individuals are so common that it is viewed by many as common practice.

Most sales to retailers are factored and are thus controlled to a great extent. However, house sales to accounts that have not been approved and sales of overruns, samples, damages, and excess piece goods which necessarily occur, are not factored and may not be subject to adequate controls. Greater efficiencies on the part of the manufacturer can help reduce the quantity of excess merchandise at the end of a season. There will always be some on hand because returned goods and canceled orders may not always be resold before the end of the season and because goods acquired in anticipation of sales may fall victim to sluggish orders.

Ideally, one could trace production from raw material to finished goods to sales or inventory with some degree of accuracy, and this is undoubtedly true for many manufacturing processes and perhaps some garment industry giants. It is certainly not true of most garment manufacturers because many are closely held and internal controls in such situations are subject to change on the word of a principal.

Even if internal controls were inviolate, there would still be "shrinkage," and such complaints are voiced by many garment manufacturers. In this sense "shrinkage" can mean a yield of finished goods that is lower than anticipated given the raw materials committed, or that finished goods taken into inventory disappeared prior to sale. Specifically, a shipment of fabric may contain more flaws than is usual, requiring extensive splicing which reduces yield. Or a cutter with a side business may hold out a ply or two of a cut to complete and sell himself. Also, a few garments may be pilfered in the factory or at the sewing contractor, or withdrawn for personal use with approval.

If a manufacturer notices that a particular outside cutter consistently produces a lower yield, he or she might switch. If he or she is informed that his or her goods are being sold at a local swap meet, he or she would investigate. A small amount of shrinkage is expected, however. While some controls are usually in place, most find the problem too expensive to fully control and pursue on a regular basis.

It is possible to trace units of finished goods produced and delivered through documents generated at each level of production. However, a moderate sized manufacturer generates many thousands of such documents in the course of a year, and inaccurate documentation or computation and missing documents at any stage can cause an analysis to produce erroneous or misleading results and conclusions.

If a shareholder's standard of living is incongruent with his or her reported income and assets, the examiner may want to explore the possibility that unreported sales is a cause of this, and he or she has the option of examining the shareholder's return. A bank deposit analysis or other indirect examination technique might be used in such a shareholder audit.

However, a bank deposit analysis of a corporation or other entity that has a double entry set of books that balance is not recommended to identify unreported income.

If there are strong indications of unreported income and sales records show at least some sales to jobbers, third party contact might be made to confirm total sales to jobbers. While not all cash and jobber sales go unreported, this technique may help identify unreported income.

SALES RETURNS AND ALLOWANCES

NOTE: *[The following discussion is based on research gathered from manufacturers employing the Periodic Method of Inventory Accounting. It should be noted that under the Perpetual Method of Inventory Accounting, (usually employed by large Manufacturers) when an item is sold, the manufacturer makes two related journal entries. The manufacturer: (1) debits accounts receivable and credit sales; and (2) debits costs of sales and credits inventory. When the manufacturer reverses a sales/accounts receivable entry to account for a returned item, it must also reverse the accompanying inventory/cost of sales entry to clearly reflect income.]*

Garment manufacturers usually report sales at gross and indicate sales returns and allowances as a reduction to arrive at net sales as indicated on the tax return. Occasionally sales are shown as a net figure only. There will always be some sales returns, allowance, and discounts, and these will most commonly be shown in the manufacturer's books as several segregated contra accounts. Occasionally a return or allowance will be debited directly to the sales account from the charge back or cash receipts journal, but this is certainly not the norm.

Reasons for returns, allowances and discounts are varied and the names of the accounts found in the manufacturers books may reflect several types of allowances. Some of the reasons for price reduction and a description of some of the allowances common to the industry appear below. You may encounter variations on many of the discounts and allowances described.

Returns

Items may be returned because of poor fit or quality, shipment of the wrong size or color, damages or simply for late shipment and delivery. A shipment arriving later than the promised delivery date may be refused.

Allowances in General Price concessions may be made for the same conditions as outlined for returns or for shortages and disputed pricing. If the customer is willing to accept substitute, damaged, or tardy shipments he or she will usually demand some kind of allowance from the manufacturer.

Warehouse Allowance

A warehouse allowance is a 2-3 percent discount demanded by many mass merchandisers. It may be accounted for by being indicated as a reduction in price shown directly on the manufacturer's invoice with a reduced net billing or as a charge back later made by the retailer through the factor. The rationale for this allowance, or discount, is that these retailers re-ship to their stores from a central warehouse, enabling the manufacturer to make a single bulk shipment to the warehouse instead of shipping to the individual stores making up the chain. The amount and terms of the allowance are often printed on the purchase order form.

Markdown Allowance

A markdown allowance is generally negotiated with better customers and is based on the likelihood that markdowns from full retail price may need to be taken in order for the retailer to dispose of some of the shipment. Such an allowance may be demanded as a concession by larger retailers, and if this is the case, the terms may appear on their purchase orders.

Year-end Allowance

A year-end allowance is customary with some manufacturers and is usually given only to their best customers, but may also be allowed to some of their older customers regardless of volume. The allowance is generally negotiated at an amount usually equal to 1 to 3 percent of annual calendar year sales. The allowance is taken by the retailer as a credit against his or her outstanding accounts payable in the subsequent year. If a $30,000 total allowance is due the customer they will generally take the credit at $10,000 a month over 3 months or $5,000 a month over 6 months either by agreement or as a courtesy to the manufacturer.

Volume Allowance

Volume allowance is much the same as a year-end allowance but is granted based on annual volume only with a threshold figure set before the allowance of any discount. The discount allowed will generally increase as annual volume passes designated amounts.

Advertising Allowance

An advertising allowance may be allowed the retailer for cooperative advertising. It is usually allowed only to larger retailers with which the manufacturer does a substantial volume of business. The retailer arranges media advertising, catalog, or direct mail promotions featuring the manufacturer's garments. The manufacturer's share of the advertising is deducted from amounts otherwise owed to the manufacturer by the retailer.

Trade Discounts

A traditional 8 percent discount is still demanded by many of the better department stores. The store will account for the purchase at cost before the discount and base their selling price on a mark-up from this figure. The usual mark up is 100 percent or double cost, sometimes referred to as 50 percent. The practice of doubling cost to arrive at retail price is known as "keystoning." It is interesting to note that many manufacturers will mark up their usual selling price to absorb the trade discount; they will sell the equivalent of $92 in goods to the department store for $100, then allow an $8 trade discount.

Cash Discounts

A discount is sometimes allowed for prompt payment of bills by retailers. Sometimes buyers will claim an anticipation amount when paying factored amounts prior to the due date. The amount is based on interest rates prevailing at the time of payment.

Accounting for Returns, Allowances, and Discounts

The retailer claiming an allowance on a manufacturer's invoice or returning items, will issue a credit memo describing the reason for the reduction, often citing authorization by the manufacturer or his/her sales staff. If part or all of the goods are returned, a copy of the credit memo may accompany the returned merchandise. Often, the manufacturer is initially notified less formally that a problem exists, and the amount of the allowance, if not fixed by contract, is then negotiated. The retailer's credit memo will then be sent to the factor with payment for the balance of the invoice. The deduction will appear on the factor's statement to the manufacturer as a charge back in the month payment is received.

The manufacturer does not always receive advance notification of a customer's claim and may not become aware of a dispute until receipt of the factor's statement, customer payment, or later.

Fixed discounts or allowances are sometimes accounted for on the invoice date through the sales journal by crediting sales for the gross sales price and debiting the allowance or discount account and the receivable account (either accounts receivable or due from factor). Where the allowance is not certain, sales will be credited and the receivable debited when the goods are shipped. When the customer's payment is received with a credit memo, and the manufacturer has agreed to an allowance or goods are returned, the entries will be credit the receivable account and debit cash and returns, allowances or discounts.

Not all retailers' credit memos reflecting disputed pricing, freight charge backs, discount demands, or other concessions are accepted by the manufacturer. Claims that have no merit and are not part of a prior agreement are often pursued for collection. The amount remains as a house account receivable, or if charged back by the factor, is transferred to an asset account titled disputed charge backs or some similar name, and attempt is made to secure payment of all or part of the disputed amount. It remains in the account until payment is secured, settlement is reached, or the pursuit of collection is abandoned.

Accruing Returns, Allowances, and Discounts At Year-end

Accruals for returns and allowances at year-end have been common audit issues, complicated by the fact that some accruals are proper for financial statement purposes but not for tax purposes. Another complication is the need for accruals because of the involvement of a factor in manufacturers' operations.

This latter situation is illustrated by reviewing the mechanics of posting returns and allowances attributable to receivables that have been factored. Normally, the manufacturer posts returns and allowances from factored sales only after they are shown as charge backs on the month end statements received from the factor. However, there is often a delay between the time a return/allowance is agreed to by the manufacturer and its appearance on the factor's statement. Therefore, year-end approved returns/allowances that have not yet been reflected on the factor statement by the close of the period should be accrued.

Under the circumstances described above, there is no argument that an accrual is warranted. The issue is whether the accrual made to reflect these "in-transit" items is accurate or whether it is overstated. If the accrual is determined by specific identification of each return/allowance amount that was in-transit as of the end of the year, there would be no issue. However, because the accrual is normally an estimate, the applicable rule of law is whether the amount can be determined with reasonable accuracy (Treas. Regs. section 1.446-1(c)(1)(ii)). The estimate is sometimes made by taking a percentage of year-end sales; sometimes it is made by totaling all charge backs (or charge backs written off) for the first X weeks or months of the subsequent year; sometimes it is an amount that has been used as the estimate from year to year.

Whatever the means of determining the year-end accrual for in-transit allowances, the manufacturer has the burden of demonstrating that the amount is an accurate reflection of returns/allowances that had been agreed to by year-end.

Differences between tax and financial accounting guidelines are responsible for other accrual issues. For example, when manufacturers offer a cash discount for early payment, they may estimate that a historical percentage of recently billed customers will take advantage of the discount by paying their bills early. Similarly, past experience may show that a certain percentage of sales will be nullified by returns/allowances after the year-end. Under these circumstances, the manufacturer accrues estimated deductions for the anticipated discounts, returns, and allowances. While these estimates are allowable for financial accounting purposes, for tax accounting purposes the issues are the "all events" and the "reasonable accuracy" tests of Treas. Reg. section 1.446-1(c)(1)(ii), as well as the "economic performance" requirement of IRC section 461(h).

A variation on the preceding situation is an accrual based on credit memos issued in the subsequent year which were attributable to sales of the current year. The manufacturer's rationale is that discounts returns, or allowances should be "matched" with their originating sales. Though this type of accrual may be computed by tabulating credit memos issued in the months following the close of the current tax year, it too must be measured against the "all events," "reasonable accuracy," and "economic performance" tests of proper accruals.

The accruals described above may be recorded in reserve accounts that are shown as contra assets accounts titled "Reserve for Discounts," "Reserve for Returns/ Allowances," "Reserve for Charge backs," or something similar. When these types of reserves are credited, the corresponding debits are to expense accounts.

Alternatively, and perhaps more frequently, adjusting journal entries at year-end debit returns/allowances (for example) and credit receivables (or due from factor) directly, without the use of a reserve account. Such journal entries will be reversed at the start of the subsequent year. Accruals that use this second method are identified by inspection of the year-end adjusting journal entries and the corresponding general ledger accounts, which will open with large reversing entries and close with one more large adjusting entries.

There are, of course, many variations on the methods used to post these accruals, but those mentioned above are typical.

This discussion is by no means an exhaustive listing of year-end accruals that generate audit issues. For instance, some manufacturers accrue deductions for advertising allowances, trade discounts, and various other allowance categories. Whatever the reason for the accruals, the permissibility would be determined by applying the "all events" and "reasonable accuracy" tests of Treas. Reg. section 1 446-1(c)(1)(ii) and, if applicable, the "economic performance" test of IRC section 461(h). IRC section 461(h) was enacted in the Deficit Reduction Act of 1984 and is effective for deductions which would be allowable (determined without regard to the provisions of the Act) after July 18, 1984.

The portions of the Cost of Goods Sold section describing changing an accounting method when making an inventory adjustment and discussing the effect of rollover adjustments are also applicable to accrual adjustments and should be consulted.

DISPUTED CHARGE BACKS

When a manufacturer analyzes the factor charge backs at the end of each month, some are quickly identified as returns or allowances that he or she previously approved. These items are charged to the appropriate expense account. Others are not so easily resolved. They may be proper deductions that will be recognized after some customer account research, or they may be unauthorized deductions taken by customers, which will be pursued for eventual collection. Charge backs that cannot be charged to an expense at the time, that the factor statement activity is initially processed are reclassified from "Due From Factor" to another receivables account, often one titled, "Disputed Charge backs."

Manufacturers have widely differing policies with regard to these disputed charge backs. Some will take an aggressive position in pursuing collection directly from the customer. These manufacturers will also likely have accounting departments that are conscientious about keeping the accounts in this category current, that is, they try to collect from those with potential and quickly write-off those deemed uncollectible. At the other end of the spectrum are manufacturers who use the Disputes account as a "dumping ground" for charge backs and whose accounting departments are so overwhelmed that the balance in Disputes gets larger and larger each month, while the individual receivables get correspondingly older.

The potential audit issue arises at the year-end, if a manufacturer writes off a significant portion of the account balance without doing a receivable-by-receivable analysis of the aging schedule to determine which are wholly or partially worthless within the meaning of IRC section 166. However, the adjusting journal entries to write-off disputes at year-end are frequently reversed at the start of the subsequent year, to restore the balance.

The examiner can only determine the propriety of the write-off after considering the following:

1. Has the manufacturer carried his or her burden of establishing the extent to which the written off disputed charge backs are worthless?

2. If the disputes are truly worthless, why is the entry reversed in the subsequent year?

3. Is the mass write-off consistent with the taxpayer's practice the rest of the year? In other words, if the accounting department aggressively pursues most disputes, why should there be a large write-off at year-end?

The manufacturer's usual practices regarding disputes may be gleaned from reviewing an aging schedule (the older the dispute, the less collectible it becomes), reviewing the general ledger activity in the disputes account throughout the year and not just at year-end, and also by interviewing the employee(s) responsible for "working" the disputed charge backs.

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Chapter 7

COST OF GOODS SOLD

INTRODUCTION

The total cost of goods sold (COGS) amount is normally the largest "deduction" item on a manufacturer's tax return, which should be justification enough for significant examination time. However, there is a more practical and compelling reason for suggesting that significant audit time be invested in the cost of sales components. In the returns that were audited prior to compilation of this information package, substantial adjustments were made in various segments of the cost of goods sold section. Not every return contained a COGS adjustment, but audit changes occurred frequently enough, and were of such magnitude, that their existence in this area should be anticipated.

This narrative addresses cost of sales components in approximately the same order that an examiner would consider them:

1. Purchases

2. Labor

3. Other Costs

4. IRC section 263A Costs

5. Inventory

In addition, inventory is divided into the following subheadings, to allow for a more thorough discussion:

1. Why audit inventory when all adjustments are "rollovers"?

2. Description of a garment manufacturer's inventory records.

3. Some audit inquiries for the basic components of inventory (piece goods and trim, work in process, finished goods).

4. Uniform capitalization requirement of IRC section 263A.

5. Changing an accounting method relative to an inventory adjustment.

Schedule A of a current Form 1120 has been reprinted below for reference (See Figure 7-1). While the discussion that follows is designed to provide practical audit suggestions, it should not be used as a step-by-step audit procedure, nor should it be considered an exhaustive approach to the issue.

Figure 7-1

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* Form 1120(1989)                                                              Page 2
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* Cost of Goods Sold and/or Operations (see instructions for line 2, page 1).
*
/)))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))))
* 1. Inventory at beginning of year ........................................ 1  *__
* 2. Purchases ............................................................. 2  *__
* 3. Cost of Labor ......................................................... 3  *__
* 4. 4a Additional IRC section 263A costs (see instructions--attach schedule) 4a *__
*     b Other costs (attach schedule) ...................................... 4b *__
* 5. Total--Add lines 1 through ............................................ 5  *__
* 6. Inventory at end of year .............................................. 6  *__
* 7. Cost of goods sold and/or operations -Line 5 less line 6.  Enter here      *
*    and on line 2, page 1 ................................................. 7  *__
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PERIOD COSTS

Purchases

Though "purchases" is a single line item in the cost of sales computation, the trial balance and general ledger will contain several categories of purchases that will be aggregated for tax return and financial statement purposes. Some of the more common ones include piece goods, findings, trim, sample piece goods, and finished goods purchased for resale. Audit of these components will normally be by routine sampling.

"Fabricated" purchases should not be dismissed automatically, regardless of how unlikely they may seem. In the early 1980's, Manhattan District uncovered several variations of "invoice" schemes in well publicized, far-reaching investigations. One involved payments for merchandise that were documented by invoices and canceled checks. The principal of the manufacturer arranged for an invoice seller to provide invoices for merchandise which would be paid in the same manner as bona fide purchases. The invoice seller negotiated the checks and returned the cash to the principal (less a fee), outside of the manufacturer's books. If an examiner sampled purchases that included fabricated ones, he or she would be presented with an invoice as well as proof of payment for the bogus amounts.

A second scheme was perpetrated by outsiders against a manufacturer, but with the help of a key manufacturing employee, the controller. The outsiders operated in the form of numerous fictitious suppliers that billed the manufacturer for a variety of merchandise. Payment of these invoices was authorized by the dishonest controller. The tax effects of this arrangement was one of timing difference, disallowance in the initial year, and a theft deduction in the year of discovery.

Improper purchase accruals, based on fabricated invoices, were detected locally in an isolated instance. In that case, the taxpayer did not contest the finding that the invoices were illegitimate, but instead, contended that the ending inventory included the goods in question, so that there was no net tax effect. Subsequent evaluation of taxpayer's position found that the ending inventory did include some of the "phantom goods," but significantly less than had been accrued in purchases.

Since nonexistent purchases are often evidenced by fabricated invoices, and sometimes by canceled checks, how can the examiner distinguish them from proper ones? There is no one "key" to identifying such arrangements. However, comparisons with legitimate purchases would likely reveal differences in one or more of the following areas:

1. Unusual endorsement on checks, such as the name of the endorser, or location of the bank negotiating the check, or cashing of the check by a check cashing business.

2. Unusual supplier or payee name. Names of many established fabric and trim suppliers will become familiar to the examiner after auditing several different garment manufacturers.

3. Appearance of the invoice, such as the type of goods, or quantities, or payment terms, or prices, or signature of receipt acknowledgment.

4. Absence of usual attachments to the invoices. Most manufacturers' accounting procedures include attaching the following types of documents to the purchase invoices: purchase order, packing slip, shipping documents, receiving verification, and customs documents.

Of a less serious nature than fabricated invoices, but which would also provide a tax benefit, is the practice of including subsequent year purchases in the ending accrual when the goods in question are not also inventoried. Though this would only provide a timing benefit, it could result in a long term deferral if it occurs every year. Checking cut-offs is easily included as part of normal sampling, and takes little additional time.

When sampling purchases accounts, selecting transactions from the last months of the year and from the ending accruals can serve two audit purposes: 1) determining the potential adjustment in a purchases sample, and 2) examining inventory. The closer to the end of the year that a purchase is made, the more likely that it would still be separately identifiable in the inventory records at year-end.

For example, if 10,000 yards of piece goods #12345 were in-transit as of the close of the year, or if the yardage was received a few days before the end of the year, it should appear in the piece goods inventory detail. Otherwise, the taxpayer should be expected to show that it had been cut and put in process; a cost sheet, cutting ticket, cutting invoice, and sometimes a material swatch are commonly used by manufacturers to demonstrate the movement of piece goods into production.

A final observation concerning purchases involves year-end goods in-transit, their deduction as part of purchases, and their exclusion from the final inventory. The reason for this inconsistency is that the inventory count is often done by production or warehouse personnel, based on what they see; on the other hand, the accounting for purchases is based on documents that follow a systematic processing route, and are much less likely to be overlooked. Unless this discrepancy is corrected in the audit, the manufacturer would receive an accelerated deduction for the amount that was not inventoried.

Labor

Common labor costs incurred for in-house operations include wages for design department employees, sample and duplicates sewing employees, cutting room employees. The amount of in-house labor cost is directly related to the extent to which production is completed in-house instead of being contracted out. As explained in an earlier section of this Guide, many manufacturers contract out all production cutting and all production sewing. In these situations, the largest general ledger amounts under "labor" will reflect payments to cutting and sewing contractors.

Straight sampling is the usual method of testing these contractor expenses. Including items at or near the year-end can serve the same two purposes as mentioned in the purchases comments above. For example, if the disbursements made in the last month of the year and the ending accrual were sampled, the documentation for these liabilities could be used in two ways: 1) To verify the legitimacy of the contractor deduction, and 2) To test ending inventory of finished goods. Because there is usually 3-5 days delay between the delivery of finished goods by the contractor and payment for those goods, the ending accrual should relate to goods that have been returned before year-end, for which payment has not yet been made.

These goods should be evident in the finished goods inventory of the manufacturer, or they should appear on sales invoices (and therefore be included in sales) dated before the end of the fiscal year. Although it is possible that goods completed this late in the fiscal year might be shipped immediately to customers, more often than not they await shipment for a longer period. The reason is that manufacturers prefer a "cushion" between the time they expect a contractor to return completed garments and the time when they expect to send an order to a customer. Sewing completion dates that are very close to the order shipment dates are avoided whenever possible.

Because several persons are normally involved in the accounting function of a manufacturer, the taxpayer will normally have an invoice or some type of document to evidence contractor deductions. But just as with purchases, "fabricated" deduction schemes should not be automatically dismissed. They have been identified locally by the Research and Development Group.

Newspaper articles have described how a manufacturer agreed to pay higher than normal sewing rates to some of its contractors, with the understanding that the contractors would rebate or kick back the excessive amounts to the owners or production managers of the manufacturing business. The manufacturer would in effect deduct amounts that were being diverted to others, who presumably did not report these amounts as taxable income.

In another situation, near its year-end, a manufacturer dramatically increased rates paid to one particular contractor (which was organized as an S-Corporation). It was determined that this contracting business was owned by the parents of the manufacturer principals, but the parents had no experience in the contracting business and were never present. The purpose of the rate increase was to ensure that the S-Corporation showed a profit at year-end, which would be taxed to the parents. Since they had no other income, they paid very little income tax. Prior to this scheme, the children had been supporting their parents through their own salaries, which were taxed at much higher marginal rates.

In yet another situation, the manufacturer used invoices with the name of a fictitious cutting company, at a nonexistent address. These invoices were paid by the accounting department just as similar, though legitimate, invoices were paid. The checks were cashed at check cashing businesses, and the proceeds apparently diverted for the benefit of the owners of the manufacturing business.

These descriptions show different levels of sophistication, and different degrees of scrutiny are required to identify the sch Granted, they are "hidden" in the midst of general ledger accounts which reflect large dollar volume in comparison with other accounts, but various indicators often point to irregularities which warrant further attention. For example, significant rate differences paid to different contractors for the same style garment might be suspect. Even if a particular style were completed only by one questionable contractor, the rates for similar styles could serve as a basis for comparison. In addition, invoices from nonexistent contractors are likely to have a very different appearance than those dealing at arm's length with the manufacturer. Attached to legitimate invoices might be some or all of the following items:

1. Notations entered by the manufacturer's shipping/receiving employees, as they verify the number of completed units.

2. Debit memos for damaged, soiled, or missing units.

3. Contractor's written comments on invoices transmitting units that have been reworked.

4. Transmittal documents on which the contractor acknowledged receipt of the goods when it was placed with his/her shop.

In addition, if an examiner follows the "trail" of a nonexistent/bogus firm, he or she will usually find that it does not have an employer identification number, does not file Forms 940 or 941, is not registered with the state where required, and probably will not have been issued a Form 1099, if applicable.

The major points in the Purchases and Labor sections can be restated and summarized as follows: Routine sampling can be used to test the legitimacy of deductions, but routine sampling procedures can be coupled with careful selection of items to sample, so that the documents reviewed can be used for both deduction testing and inventory testing. Because these general ledger accounts are often among the largest deduction categories on tax returns, they have been used to mask various tax avoidance and tax evasion schemes. These schemes are not engaged in by a majority of manufacturers, but be aware that they do exist, and that they have been identified in the course of other audits.

Other Costs

General and administrative costs allocable to production activities are usually grouped under this category. They include such costs as depreciation, rent, utilities, and insurance. If they are audited, routine sampling is usually the method used. Contract labor for cutting and sewing is often included in this category. If so, the above comments in the "Labor" section would be pertinent.

IRC section 263A

As applicable to garment manufacturers, IRC section 263A requires that for tax years beginning after December 31, 1986, manufacturers must capitalize (include in inventory):

1. All direct costs of inventory at year-end, and
2. The indirect costs of such inventory.

Tax returns for years beginning in 1987 contain a separate cost of sales line for IRC section 263A costs not already included in one of the other categories above. Audit of these costs can test the total amounts reportedly incurred in these accounts, but the existence of a separate line for "other IRC section 263A costs" does not by itself mean that the correct amount of direct and indirect costs have been included in inventory pursuant to IRC section 263A. A cost element has not been included in inventory unless an allocable portion has been included in the ending inventory amount.

Stated another way: Whether the "Other IRC section 263A Costs" line is blank or whether it includes large dollar amounts, the examiner has no way to tell from this line entry alone whether the taxpayer has complied with the uniform capitalization requirements of IRC section 263A. The following section includes comments on examination of the IRC section 263A issue.

ENDING INVENTORY

The topics to be addressed in this section are as follows:

1. Why audit inventory when all adjustments are "rollovers"?

2. Description of a garment manufacturer's inventory records.

3. Some audit inquiries for the basic components of inventory (piece goods and trim, work in process, finished goods).

4. Uniform capitalization requirement of IRC section 263A, as applicable to garment manufacturers.

5. Changing an accounting method relative to an inventory adjustment.

From an income tax audit perspective, the inquiries in this area focus on whether the ending inventory is understated. Manipulation of the ending inventory total allows a taxpayer to directly affect its income tax liability:

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Understatement of ending inventory = Understatement of tax liability
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Why Audit Inventory When All Adjustments Are "Rollovers?"

Despite the potential for tax avoidance inherent in the ending inventory, examiners often perform only a cursory review of ending inventory, with the justification that any adjustment is only a "rollovers" adjustment, that is, an increase of taxable income in Year 1 is offset by a corresponding decrease of taxable income in Year 2. If this is the result (this line of reasoning continues), why bother pursuing the issue? Why bother with an adjustment if the net effect is only a timing difference, and therefore, only results in an "interest owed" effect?

This type of adjustment is typified in the following example. Taxpayer reported the following:

Example 1

	YEAR 1	YEAR 2
Opening Inventory	500,000	750,000
Costs	6,000,000	7,000,000
Ending Inventory	(750,000)	(1,000,000)
	-----------	-----------
Cost of Sales	5,750,000	6,750,000
	=========	=========

If the examiner found a clerical error resulting in $25,000 being omitted from the ending inventory of Year 1, the potential adjustment would be the following:

Example 2

	YEAR 1	YEAR 2
Opening Inventory	500,000	775,000
Costs	6,000,000	7,000,000
Ending Inventory	(775,000)	(1,000,000)
	----------	-----------
Cost of Sales	5,725,000	6,775,000
	=========	=========

Cost of Sales RAR Adjustment: Year 1 = 5,750,000 - 5,725,000 = 25,000

Cost of Sales RAR Adjustment: Year 2 = 6,750,000 - 6,775,000 = (25,000)

This example illustrates a "correction of an error," which includes misstatements of amounts due to mathematical error, computational error, or posting error. These adjustments result in one time, one year rollovers audit adjustments. An examiner finding such an error in inventory might decide not to make the adjustment because 1) the error does not materially distort taxable income, and 2) the one year rollovers would not result in a material amount of interest owed by the taxpayer. On the other hand, an examiner might propose the adjustment if tax rate differences between years result in a significant net increase in tax or if the interest differential is significant.

The above example illustrates the CORRECTION OF AN ERROR. Another type of inventory audit adjustment is of an entirely different character. It involves IMPROPER METHODS of accounting for various elements in the ending inventory.

Tax literature goes into great depth discussing accounting methods and changes to these methods. Even a simple definition in the regulations can be daunting, as shown at Treas. Reg. section 1.446-1(e)(2)(ii)(a): "A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment."

More enlightening to understanding a "method of accounting" as affecting inventory may be a few examples that relate specifically to garment manufacturers (without addressing the "right" or "wrong" of the various methods):

1. Valuing piece goods from prior seasons at a fraction of original cost.

2. Excluding freight-in costs from items in inventory.

3. Excluding sewing contractor costs from work in process.

4. Using a standard cost of 10 cents per unit for such miscellaneous costs of finished goods as plastic bags, hangers, pins, cardboard.

5. Reducing finished goods quantities by customers' orders which are in hand, but which have not yet been "shipped," that is, recorded as sales.

The common element of these "method" examples are that these practices are followed consistently, routinely, and regularly.

So what is the tax effect difference between correcting an error and making a change in accounting method? As seen in the example of the error that was corrected above, the effect on taxable income was "netted" in the space of 2 years. "Errors" correct themselves within a specific time period, usually 2 years. In contrast, because improper "methods" involve regular and routine accounting practices, the permanent correction will often not take place until the examiner addresses the issue beginning with the return being audited and ending with the most recently filed return. Until the change is made, the taxpayer can have the benefit of an indefinite deferral of taxes.

Example 3 demonstrates that an accounting method change often results in a tax adjustment whose effect is not "reversed" in the foreseeable future. To highlight this observation, the only variable is the assumption that each year, the taxpayer deducted an improper inventory write-down of $200,000. All other factors in the cost of sales equation remain constant.

Example 3

COST OF SALES AS FILED

	Audit Year 1	Audit Year 2	Audit Year 3	Audit Year 4	Audit Year 5
Beginning Inventory	750,000	750,000	750,000	750,000	750,000
Costs	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000
Ending Inventory	(750,000)	(750,000)	(750,000)	(750,000)	(750,000)
COGS	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000

COST OF SALES AS CORRECTED

	Audit Year 1	Audit Year 2	Audit Year 3	Audit Year 4	Audit Year 5
Beginning Inventory	950,000	950,000	950,000	950,000	950,000
Costs	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000
Ending Inventory	(950,000)	(950,000)	(950,000)	(950,000)	(950,000)
COGS	6,000,000	6,000,000	6,000,000	6,000,000	6,000,000

AUDIT ADJUSTMENTS

	Audit Year 1	Audit Year 2	Audit Year 3	Audit Year 4	Audit Year 5
Beginning Inventory (Curr. Yr. Adjust.)	(200,000)	(200,000)	(200,000)	(200,000)	(200,000)
Ending Inventory (Curr. Yr. Adjust.)	200,000	200,000	200,000	200,000	200,000
IRC 481(a) Adjustment	200,000	n/a	n/a	n/a	n/a
Net Increase to T.I.	200,000	0	0	0	0

In this example, when the size of the inventory understatement is constant from year to year, the deferral that the taxpayer was enjoying is taken away in the first year of the examination, and the taxable income effects are not "reversed" in the years shown. If the size of the understatement INCREASED from year to year, years 2-5 would reflect net adjustments for the incremental increases. Conversely, if the size of the understatement DECREASED after Year 1, adjustments would be made to reverse the Year 1 adjustment, to the extent of the decrease.

To reiterate: When an incorrect method of accounting for inventory is changed, the examiner might be correcting a practice that would give the taxpayer a very long (sometimes indefinite) deferral of income taxes.

In summary, this section presented rudimentary examples to demonstrate that auditing ending inventory should not be dismissed on the assumption that inventory adjustments result in "only" rollovers. An accounting method change in inventory may take away an essentially permanent deferral, which by itself is a substantial tax benefit. Also, even a one year rollovers adjustment may at times be advisable if the adjustment is large enough to result in a significant interest factor, or if tax rate differences between years result in a net increase in tax.

Description of Inventory Records

Although garment manufacturers are not prohibited from using LIFO to value their inventories, the flow of goods assumption used by most is FIFO. In the returns examined before preparation of this information package, all manufacturers followed a FIFO assumption.

Some type of perpetual inventory system is used by manufacturers on a daily basis for operational purposes. They range in sophistication from daily computerized reports for each major segment of inventory (piece goods, work in process, finished goods), to manual tally sheets, to notations on a blackboard. They may be maintained in one location, or they may be maintained in several different locations. Whether or not taxpayers refer to these as perpetual inventory records, this is the means of knowing on a day-to-day basis, for example, how many yards of a certain fabric are uncut, or how many units of specific styles are still in a contractor's shop being sewn, or how many units of style X are ready for shipment.

For financial statement and tax return purposes, however, manufacturers will take a PHYSICAL INVENTORY at year-end. These are the physical inventory records that will be presented to the examiner in the audit. The examiner should request the following documents supporting the ending inventory reported on the return:

1. Summary/recap sheets

2. Detail sheets

3. Count sheets

4. IRC section 263A computations.

The summary sheet should contain an ending inventory total that can be traced directly to the tax return. In addition, the total should be fragmented into the major components of inventory:

1. Piece goods (PG) - Should represent fabric that has not yet been cut, plus related costs such as freight.

2. Work-in-process (WIP) - Should represent the freight, materials, and labor (except contractor sewing labor) for everything from fabric that has just been cut to garments that have been completed but not yet returned by contractors to the manufacturer.

3. Finished goods (FG) - Should represent the freight, materials, and labor for finished goods that have not yet been shipped to customers.

4. Trim - Should represent findings and trim that have not yet been incorporated into a partially or completely finished garment. Sometimes these items are included under the piece goods category; sometimes they are omitted from ending inventory.

5. IRC section 263A computation - Should identify all categories of additional costs that are inventoried via the year end computation, as well as the calculations to arrive at the amount added to the ending inventory.

Piece goods, work in process, finished goods, and trim represent direct costs, and they are normally derived from the physical inventory conducted by the manufacturer's employees. The IRC section 263A component (indirect costs) will usually be an amount calculated by the manufacturer's accountant for tax return purposes, and should be supported by work papers.

Detail sheets supporting the summary sheet totals for PG, WIP, FG, and trim normally contain the following items of information:

1. PG - Name of mill, the mill's piece goods number, description of fabric, colors, yards of each color, cost per yard, extension of yards/cost.

2. WIP - Style number, cut number, units or dozens, cost per unit or cost per dozen, extension of units or dozen/cost.

3. FG - Style number, units or dozens, cost per unit or cost per dozen, extension of units or dozen/cost.

4. Trim - Description of item, units or dozens or gross, cost per unit or cost per dozen or cost per gross, extension of quantity/cost.

Count sheets are most often presented to the examiner when the inventory process utilized prenumbered count sheets and controlled procedures. When they are not made available to the examiner, the explanations are often that:

1. Count sheets were not used; the tabulations were entered directly on the detail sheets.

2. The count sheets were thrown out after the detail sheets were prepared.

3. They cannot be located.

IRC section 263A costs not already inventoried via their inclusion in PG, WIP, and FG are added to inventory by means of side calculations. A garment manufacturer would not likely maintain an elaborate cost system expressly to segregate and tabulate IRC section 263A costs. Therefore, the key records for this element of inventory are work papers detailing 1) the specific costs subject to capitalization, and 2) the computations applied to these costs, in arriving at the allocable portion.

Some Suggested Audit Inquiries

To repeat a previous comment, the focus of the ending inventory examination is to determine whether the inventory is understated. In other words, have certain costs been omitted? Have units of inventory been omitted?

Theoretically, many tests of the units and of the costs included in inventory are possible. The comments that follow recognize, however, that there are various considerations which limit the audit scope of the inventory examination. One of these is of course the time available to the examiner; another is the number of persons conducting the audit, which is usually one. Therefore, the following suggestions take a practical approach to auditing a garment manufacturer's inventory, and every effort is made to balance expediency with thoroughness.

Be aware that the procedures enumerated here are not the only procedures that can be performed in the audit of a garment manufacturer's inventory. As one becomes more familiar with the workings of the industry in general, with the operations of manufacturers, and with the production (as opposed to the accounting) documentation, variations and alternatives will be developed to improve the examiner's effectiveness in this area.

Footings and Extensions

This step should be so "automatic" that it should not have to be mentioned. However, it is included as a reminder because the findings of one case reinforced the importance of verifying this clerical procedure. A medium sized manufacturer, organized with many formal accounting guidelines, used prenumbered inventory count sheets to take the inventory. All items were carefully combined into detail sheets. However, not until the company's internal audit testing was conducted were the footing errors identified. They occurred on several detail sheets, and the errors total led to over $1.5 million.

Examiners sometimes limit their inventory audit to testing the footings and extensions of taxpayer's inventory sheets. This is a first step, but it should by no means be the scope of the inventory review.

Piece Goods

Units Omissions. Prior season piece goods are often not included in inventory. The manufacturer may intuitively feel that they are worth much less than when they were to be used to produce first line goods, but the fact that piece goods were purchased for a prior season has nothing to do with whether they should be included in inventory, and (as explained below in the "markdown" discussion) very little to do with how they should be valued.

A good time to start considering this issue of uncounted prior season piece goods is during the tour of the facilities. If the information is not volunteered, the examiner may want to ask to see where these goods are located (because they will be segregated from the current season's piece goods) and to solicit an estimate of the yardage identified as from prior seasons. Questions about whether those are typical quantities, or about changes of quantities of prior season piece goods would be appropriate and helpful. While what the examiner sees during the initial visit will probably not be the actual goods that were on hand as of the end of the audit year, but the examiner will have a much more informed basis for discussing the issue at a later date.

Unit Omissions. The most recent purchases, that is, those made at year-end, are also commonly left out of the piece goods inventory. This omission is usually due to careless error. It can occur because the production and warehouse employees who take the physical inventory, count only what they see. Therefore, if goods are in-transit at the time of the inventory, or if they are in the process of being brought into the warehouse, they may be missed. This does not mean that the corresponding purchase costs will be left out of the cost of sales computation. Often the cost of these goods will be included in the deduction, but the goods will be omitted from inventory. Purchases at year-end should appear in ending inventory, or the taxpayer should be able to demonstrate that they were cut and placed in work in process. When evaluating such an explanation of why piece goods acquired at year-end are not in the ending piece goods inventory, the examiner should keep in mind that manufacturers do not usually cut piece goods as soon as they are received in the warehouse.

Unit Omissions. Depending on the extent and nature of records made available to the examiner, it may be possible to test for piece goods omissions by inspecting cutting tickets of cuts made in the first weeks of the subsequent year. Sometimes, a cutting ticket will contain a description as well as a swatch of the materials that will be included in a particular cut. If the examiner has access to this amount of information, he or she could test the piece goods ending inventory against the information on the cutting tickets. The piece goods should either appear in the inventory or the manufacturer should be able to demonstrate that the goods were purchased after the close of the audit year. If an examiner is considering this procedure, the location, accessibility, and type of information on cutting tickets should be determined at the tour of the facilities and during the initial interview.

Cost Omissions. Understating the costs of piece goods is another means of creating a larger cost of sales deduction. Testing the basic costs of piece goods is done by inspecting recent invoices for selected piece goods listed in the piece goods inventory detail. The unit prices from the inventory detail should at least be equal to, if not slightly higher than, those listed on the invoices. They would be slightly higher if the manufacturer recognized and accounted for a freight-in factor on the inventory records.

Cost Omissions. Though freight and customs duties should be inventoried under both financial and tax accounting rules, they are not always included in the unit cost of piece goods. The magnitude of the omission depends on the geographic location of the textile supplier, the mode of transportation, and the weight of the fabric. For example, goods acquired from a local textile vendor would have a much lower omission factor than that which was purchased from overseas, and which would have incurred air freight fees as well as customs duties and broker fees. For domestically purchased piece goods, the freight factor would be less, but could still be significant.

Write-downs. Write-downs (markdowns) of piece goods are common audit issues. Manufacturers who write down a portion of their piece goods inventory are valuing that part of the inventory at less than original cost. Write-downs are taken in several ways:

1. The piece goods inventory total on the inventory summary page may be followed by an amount by which the total is being reduced; this is usually a percentage factor or a nonspecific "round" number.

2. Specific piece goods may be written down. One method is to cross through selected cost figures on the detail sheets and substitute lower amounts. Another method is to list the written down amount as the cost figure on the detail sheet for any piece goods that the manufacturer wishes to write-down. Write-downs from this second method would be found via unit cost testing.

3. The most difficult write-down to locate in the audit is that which is taken by completely omits the item from the count and detail sheets. By doing so, the manufacturer is taking the position that the items are being written down to a zero value.

Taxpayers Explain Their Write-Downs Several Ways

1. A common rationale is that the piece goods marked down are those purchased for a prior season. Because of the fashion consciousness of the market, they reason, past seasons' fabric cannot be expected to bring the same price as current season fabric, even if the "old" piece goods are cut with current season styles. As a point in fact, manufacturers can often show that when the "old" fabric was cut with current styles, the finished goods were sold as part of an "off price" arrangement with a customer or sold to a customer who did not handle the manufacturers' first line goods.

2. Another common explanation given for piece goods write-downs is that the manufacturer values his or her inventory at the lower of cost or market, and for the piece goods written down, the market was lower.

3. Yet a third reason given for piece goods markdowns is the manufacturer's many years in the industry, which is the basis for knowing that the value of certain piece goods is less than their original cost.

4. Other manufacturers explained that their piece goods write-downs by reference to a desire to maintain a stable gross profit percentage. They reason that certain piece goods are no longer "fashionable" or "hot." Therefore, any products made with these fabrics will command lower prices. If they write-down these piece goods now, the lower costs attributable to these units will be matched with the lower prices that will be realized on sales to the customers. Therefore, the gross profit will remain the same, and income will not be distorted. (With this rationale, the taxpayer ignores the distortion to taxable income in the year that the write-down is deducted.)

None of the above positions follow the Service's position with regard to allowable write-downs. IRC section 446(b) states that a method of accounting must clearly reflect income, while IRC section 471 directs that inventories both conform to the best accounting practice in the trade or business and clearly reflect income.

A clearer, more comprehensive statement of the Service's position about inventory write-down guidelines can be gleaned from the **Thor Power Tool** case. Although the fact pattern of **Thor** is very different from that which will be found in garment manufacturer cases, the real value of the case lies in its outline of the requirements for proper tax write-downs. Its comments included the following observations:

1. Write-downs which are obviously inconsistent with the regulations do not "clearly reflect income," and the Commissioner acts within his or her discretionary power in reaching this conclusion.

2. Taxpayer must value inventory for tax purposes at cost unless "market" is lower.

3. "Market" means "current bid price," which in turn means "replacement cost, that is, the price the taxpayer would have to pay on the open market to purchase or reproduce the inventory items."

4. Taxpayer is permitted to value inventory below replacement cost ("market") only when:

   a. Merchandise is offered for sale at prices below replacement cost, or

   b. Merchandise is "defective," as described in Treas. Reg. section 1.471-2(c). (In the latter situation, the taxpayer would still have to demonstrate actual offerings of goods at below replacement cost, and these offerings would have to have been made no later than 30 days after the inventory date.)

5. It is appropriate that the burden of proof rests with the taxpayer; it is also appropriate that the taxpayer bear this burden via "hard evidence," that is, documentation of sales at the below replacement cost rates.

With these requirements in mind, one can more easily evaluate the merit of the manufacturers' justifications for write-downs.

1. The first was that the prior season fabric was out of style, and would command a lower price when sewn into a finished garment. No write-down would be allowable unless the taxpayer could show that the replacement cost of the fabric was less than its original cost, or that bona fide attempts were made to sell the fabric at the marked down price.

2. The second explanation invokes the "lower of cost or market" phrase, but the interpretation that manufacturers give "market" is very different than the tax meaning of the word. Manufacturers equate "market" with the price at which they think they could resell the piece goods; for tax purposes, "market" means replacement/reproduction cost, WHICH USUALLY APPROXIMATES OR EVEN EXCEEDS COST.

3. The third justification, years of experience, is even easier to address, since manufacturers who use this rationale have not borne any of their burden of proof. Obviously, "years of experience" is not the hard evidence envisioned by **Thor**.

4. Lastly, maintenance of the gross profit percentage is an explanation that also attempts to persuade by incorporating key words. However, the write-down guidelines still require a comparison of cost versus replacement cost versus documentation of actual sales or offerings, and these "tests" have nothing to do with the manufacturer's desire to show consistent gross profit percentages.

<u>Work-In-Process</u>

<u>Units</u> <u>Omissions</u>. Units in this category are those being cut or sewn at the time of the inventory. Once the cut numbers and style numbers have been identified for the in-process inventory, the examiner can test for omitted units. One way to do this is to first schedule the payments to cutting and sewing contractors that were made in the first 2-3 weeks of the subsequent year, then to request the documentation supporting these disbursements. The paper trail will contain dates, which will enable the examiner to verify whether specific cuts were in process at the end of the year (the cuts of interest are those in the contractors' possession at the end of the year, and returned after the end of the year).

These cuts and styles should appear in the work-in-process inventory if the inventory records are accurate.

<u>Cost Omissions</u>. Once the examiner has determined the correct quantities and styles for this inventory segment, he or she can verify the costs that should be included by reference to the cost sheets for the applicable styles. If the work is at the cutting stage, it should at least include the cost of piece goods, freight, trim, and findings. If it is at the sewing stage, the work should include all of the previous costs plus cutting costs. Manufacturers who contract out all sewing are not normally required to include a portion of sewing cost, even though at the time of inventory, it is reasonable to believe that of all cuts being sewn, a portion has already been completed.

The justification includes a combination of operational realities and tax law principles. From a production point of view, the manufacturer will not pay the sewing contractor until the goods are returned, counted, and inspected. Missing, damaged, soiled, or incorrectly sewn units require the contractor to either repair the defect or pay for the garment. Therefore, no sewing cost has been incurred by the manufacturer while a cut is in the hands of the contractor. From a tax law perspective, the manufacturer would not be entitled to accrue any portion of the anticipated sewing charges before a cut has been returned, since "all events" have not occurred to establish the fact of the liability. Therefore, requiring a manufacturer to inventory what it cannot accrue would be clearly inconsistent.

This same line of reasoning does not apply to cuts that are sewn by the manufacturer's own employees. Some sewing labor should be included for these cuts being sewn in-house, since the manufacturer has an obligation to pay his or her employees for work done, even if they have damaged the garments or sewn them incorrectly. In-house cuts are often treated as 50 percent completed for purposes of allocating sewing labor to the work in process inventory.

Write-Downs. The observations and comments with regard to piece goods write-downs also apply to markdowns of work in-process. Also, the same technical requirements must be met before a garment manufacturer is entitled to markdown this segment of inventory.

Finished Goods

Units Omissions. Finished goods include all completed units that have not been shipped. Because garment manufacturers normally record a sale only at the time that the goods are shipped, uninvoiced goods, although segregated for specific customers, should be included in inventory. If an examiner wants to test whether the manufacturer omitted significant numbers of units in anticipation of shipment in the first weeks of the following year, he or she can schedule the quantities of styles shipped in the first few days of the subsequent period. The styles shipped should appear in finished goods inventory, or be traceable to work in process that was delivered between the end of the year and the shipment date. To perform this test, sales invoices are required, as well as documentation of cuts completed and returned during the interim period (the latter items will come from contractor vendor files or from the cutting tickets historical file).

Units Omissions. Year-end journal entries often include accruals for approved "returns" which are not yet in possession of the manufacturer. If they are proper accruals, they should be included in the ending inventory at cost.

Cost Omissions. Once the examiner has determined the correct quantities and styles for this inventory segment, he or she can verify the costs that should be included by reference to the cost sheets for the applicable styles. The cost sheets, in turn, should reflect the cost of piece goods, freight, trim and findings, cutting, sewing labor, and a miscellaneous factor for hangers, bags, etc. In other words, all costs listed on a style's cost sheet should be included for inventory purposes.

Write-Downs. The observations and comments with regard to piece goods write-downs are also applicable to markdowns of finished goods. Also, the same technical requirements must be met before a garment manufacturer is entitled to markdown this segment of inventory.

Trim and Finding

Although the trim and findings for work in-process and finished goods are usually included in the inventory of those respective segments, manufacturers often do not inventory that which has not been included in a garment as of the end of the year. Chances are good that if this segment of inventory is not listed on the inventory summary as a separate item, and if it is not listed in the piece goods detail sheets, it has been completely expensed by the manufacturer (except for the items that are included in WIP and FG).

Other Omissions

There are other items purchased for inclusion in garments that should technically be inventoried. For example, hangers, plastic bags, shirt boards, shipping boxes, labels, and hang tags should all be inventoried. The cost of these types of items should be inventoried as the IRC section 263A uniform capitalization requirements are implemented. Even if they are omitted from that calculation (see below for discussion of the IRC section 263A inventory factor), the examiner will still gauge the materiality of the issue before raising it. The normal frequency and dollar volume of purchases would indicate the approximate size of any potential adjustment, as would a determination whether there were any large year-end purchases of these items.

Uniform Capitalization Requirements of IRC section 263A, as Applicable to Garment Manufacturers

A few words of caution:

1. The following discussion of IRC section 263A makes a number of assumptions about garment manufacturers' operations and the types of records they maintain. If a specific taxpayer's operations or records are radically different than the "norm," the examiner may have to use much different methods when addressing the IRC section 263A inquiries.

2. This section discusses the examination of indirect production costs.

3. The suggested audit inquiries that were outlined above, with regard to direct costs should still be made.

4. The general discussion that follows should not be considered a substitute for a thorough reading of IRC section 263 and the related regulations.

For years beginning after December 31, 1986, IRC section 263A requires garment manufacturers to capitalize, that is, include in ending inventory, 1) all direct costs of such inventory, and 2) the indirect costs of such inventory. Prior to the effective date of IRC section 263A, garment manufacturers usually inventoried all direct costs of production. These direct costs were what comprised the amounts in the manufacturers' piece goods, trim, work-in-process, and finished goods inventory components. Most manufacturers who contracted out cutting and sewing inventoried little or no indirect costs, despite the full absorption requirements of Treas. Reg. section 1.471-11. The reasons were twofold:

1. Since most production functions were contracted out, the indirect costs normally associated with production were incurred by the contractors and were included in the fees paid to them. Therefore, the manufacturer did not have significant amounts of indirect costs that had to be added to what it considered to be the direct costs of production.

2. The full absorption regulations allowed manufacturers to expense many more indirect costs.

Though IRC section 263A requires that substantially more indirect costs be inventoried, the accounting systems and inventory costing methods of garment manufacturers have remained unchanged. The examiner will not find radical overhaul of record keeping operations to comply with the uniform capitalization rules because most manufacturers continue to use their former inventory systems, while making a year-end "side calculations" to add the necessary indirect costs to ending inventory.

In an income tax audit, the focus of a IRC section 263A inquiry is whether taxpayer allocated the proper amount of INDIRECT PRODUCTION COSTS to the ending inventory. An overview of the audit of this issue follows:

1. Identify the types of production costs (both direct and indirect) that must be inventoried.

2. Determine which are already included in inventory, via the piece goods,

work-in-process, finished components (these are usually only direct costs). Allocate the remaining costs between production and non-production activities. This step isolates the total indirect production costs; a portion of this total will be allocated to ending inventory in the next step.

3. Determine what portion of total indirect production costs is allocable to ending inventory.

For purposes of applying the requirements of IRC section 263A, the above overview breaks the audit procedure into three distinct steps. Exhibit 7-1 contains a format that can be used to organize the examiner's work. It assumes use of the specific identification method (to allocate mixed service costs) and the simplified production method, (to allocate production costs to ending inventory), which are the most common calculations used by garment manufacturers to determine the indirect production costs to be added to ending inventory.

Changing an Accounting Method Relative to an Inventory Adjustment

Adjustments to ending inventory sometimes involve "corrections of errors" rather than changes to a method of accounting. If an "error" is being corrected (as opposed to a "method"), the examiner will make the adjustment to the current year return, and an increase in the ending inventory due to a correction of an error will entitle taxpayer to an offsetting increase to its beginning inventory of the following year. The timing difference is, therefore, usually a delay of only one year.

When a method of accounting is changed, however, there are three different (but related) adjustments. The first adjustment is to the ending inventory of the year of change. In addition, beginning inventory of the year of change must be restated, using the correct method of accounting. Lastly, because the restatement of the beginning inventory would give rise to a double deduction benefit to the taxpayer, this duplication is eliminated by "IRC section 481(a) amount," which is the amount by which the beginning inventory is increased.

Generally, a taxpayer that is under examination may not file an application to change an accounting method without the consent of the district director. This means that the examining agent has jurisdiction to make the change in accounting method in the earliest open year, with no spread of the IRC section 481(a) adjustment. However, Rev. Proc. 92-20 provides four opportunities ("window periods") for taxpayers who are under examination to use its more lenient guidelines for making a change of accounting method. If a taxpayer meets the criteria for one of these "window periods," he or she would file Form 3115 under the terms specified by Rev. Proc.

92-20.

Whether the accounting method change is effected under the general rule or under the provisions of Rev. Proc. 92-20, to implement the change of method the examiner must be familiar with these concepts:

1. Category A and Category B methods of accounting.

2. The "year of change."

3. The IRC section 481(a) adjustment period.

Does the change involve a Category A or a Category B method of accounting? A Category A method of accounting is a method of accounting the taxpayer is specifically not permitted to use under the Code, the regulations, or a decision of the Supreme Court of the United States. A Category A method is also a method of accounting that differs from a method that the taxpayer is specifically required to use under the Code, the regulations, or a decision of the Supreme Court of the United States.

Examples of Category A methods:

1. Omitting selected portions of goods that should be inventoried.

2. A write-down of goods in inventory that does not comply with Treas. Reg. sections 1.471-2 or 1.471-4.

3. A write-down of "excess inventory" to a net realizable value although such inventory has not been scrapped, sold, or offered for sale at the reduced price.

4. Ignoring the uniform capitalization requirements of IRC section 263A.

Category B methods of accounting are all methods other than those determined to be Category A methods of accounting. Though there is a technical distinction between A and B methods, from a practical point of view, when examiners propose a change to a method of accounting they are usually addressing Category A methods of accounting.

<u>What Is the "Year of Change?"</u>

Rev. Proc. 92-20 specifies the year of change if the taxpayer files for a change during one of the window periods. If none of the window periods are applicable (and they often are not), the year of change will be the earliest taxable year under examination.

What is the IRC section 481(a) Adjustment Period?

Rev. Proc. 92-20 specifies the adjustment period if the taxpayer files for a change during one of the window periods. If none of the window periods are applicable (and they often are not) or if under IRC section 6.06, the district director has objected to the change during the examination, the entire IRC section 481(a) amount is reported in full in the year of change. (When a taxpayer avails himself or herself of Rev. Proc. 92-20, a "commissioner" imposed method change is involved. But when a taxpayer under examination cannot use, or chooses not to use, Rev. Proc. 92-20, the taxpayer is involved in a "district director" imposed method change. The district director has not been granted the authority by the "commissioner" to offer terms and conditions as to year of change and spread periods for the IRC section 481(a) amount, such as those provided for in Rev. Proc. 92-20. Accordingly, the year of change is the earliest year under examination, and the entire IRC section 481(a) is to be considered in the year of change.

Special rules are applicable to a change in accounting method involving uniform capitalization, IRC section 263A. Rev. Proc. 94-49 governs most accounting method changes for costs subject to IRC section 263A for a taxpayer's first or second taxable year beginning on or after January 1, 1994. An IRC section 263A change in method that cannot be made pursuant to Rev. Proc. 94-49 should be made pursuant to Treas. Reg. section 1.263A-7T and Rev. Proc. 92-20, 1992-1 C.B. 685 (if the latter is applicable).

```
    STEP # 1                                   STEP # 2
 +))))))))))))),        +))))))))))))))))))))))))))))))))))))))))))))),
 *             *        *                                                *
 *             *        *                                 Percentage      *
 *             *        *                     Mixed        of Mixed       *
 *             *        *                     Service      Service        *
 *             *        *          100%     Costs to be    Costs          *
 *             *       (A)     Attributable Attributable Attributable  Mixed
    *       *       * Already *      to      *     to      *      to     *Service
    *Account*       *   in    * Production/ *Production/ * Production * Costs
G/L#*Descrip*Amount*Inventory*  Inventory *   Inventory*Inventory   *  $X%
))))3)))))))3))))))3)))))))))3))))))))))))3))))))))))))3)))))))))))))3)))))))))
    *       *       *         *            *            *             *
    *       *       *         *            *            *             *
    *       *       *         *            *            *             *
    *       *       *         *            *            *             *
    *       *       *         *            *            *             *
    *       *       *  Total  *     Total  *            *             * Total
                      4444444       4444444 \                          / 4444444

                                             \                        /
                                              \                      /
                                         Total 263A Costs to be Allocated

                              STEP # 3 (Simplified Production Method)
                        ))))))))))))))))))))))))))))))))))))))))))))          -

      Total 263A Costs           Ending Inventory           Portion of 263A
      To be Allocated            before Considering   =       Costs in
   ))))))))))))))))  -    X      IRC 263A                      Ending
    Total Production                                          Inventory
     ("Already in Inventory" Total)

     (A) = Only the G/L accounts that are included in the components of
           inventory, per return, before considering IRC section 263A.
           If a cost category was not inventoried, it does not belong
           in this column.
```

Step 1 -

The first step involves identification of all general ledger accounts that contain any production/inventory related costs. Many manufacturers divide their general ledger accounts into broad categories, such as "production," "design," "selling," and "administrative." These classifications should not be the sole means of identifying accounts with production/inventory related costs. For example, the taxpayer may list Rent Expense and Security Expense as "administrative," but if significant portions benefit the production/inventory activities, they should be so identified in this first step. In other words, the examiner should not rely solely on the taxpayer's general ledger or trial balance groupings. The following lists give examples of types of costs that should and should not be considered production costs.

Examples Of Production Costs Included In Inventory	Examples Of Production Costs Not Included In Inventory
Direct materials	Marketing
Direct labor	Selling
Repairs and maintenance	Contributions
Utilities	Advertising
Rent	Interest*
Indirect labor	Factor commissions
Indirect materials	Factor interest
Freight-in	IRC 165 losses
Supervision	Income taxes
Indirect Supplies	Non-production administrative, service, support costs
Small tools and equipment	
Quality control and inspection	Non-production officer salary**
Design and engineering costs	Freight-out
Depreciation (cost recovery)	Research and experimental costs
Taxes (except income taxes)	IRC 179 costs
Factory administrative costs	Cost recovery on idle equipment and facilities
Factory employee benefits	
Administrative, service, support costs related to production or inventory storage	Strike expenses
Off-site storage	
Purchasing	
Handling	
Officers' salaries	
Pension costs (including past service costs for years beginning after 12/31/87)	
Employee benefits	
Storage costs	
Insurance	
Licensing and franchise costs	

* = The Code and regulations recognize that under certain situations, interest may be allocable to production. As a practical matter, these situations would not arise in the case of a garment manufacturer.

** = Examples: Functions or departments responsible for overall management or for setting overall policy, and the chief executive, financial accounting, and legal of officers, provided that no substantial part of the cost of such departments or functions directly benefit a particular production activity, (for example, general business planning, financial accounting, general financial planning and financial management).

Step 2 -

The second step categorizes the costs identified in the previous step. Each cost will be in one of three categories:

1. Already in inventory. In this column is entered the general ledger totals for any account whose costs are already included

in the piece goods, work-in-process, or finished goods components of ending inventory. In most cases, this will only be direct costs. Taxpayers frequently include in this column (in error) indirect costs that are listed in the Cost of Sales section, but which are not already included in the PG, WIP, FG components of ending inventory. For example, utilities, supervisors' salaries, and rent that are attributable to production/inventory are often categorized as "already in inventory." The examiner needs only to look to the PG, WIP, FG records described earlier to determine if these elements are in fact already inventoried. If not, they most likely belong in the "100 percent production/inventory" column.

2. 100 percent attributable to production/inventory. Costs that are not already inventoried, but which are fully attributable to production/inventory activities, are included in this column.

3. Mixed service costs. These are costs which benefit both production/inventory activities and "excluded" activities. Examples are pension costs that cover employees from all departments of the company, accounting department costs, insurance for the entire plant facility, and officers' salaries that were not previously segregated by function. The specific identification method next applies a percentage to each mixed service cost amount to determine what specific amount of each category will be treated as attributable to production/inventory.

   To this point, assuming that the taxpayer used the specific identification method for computing its IRC section 263A amount, the examiner should have addressed most of the common audit inquiries for this issue:

   a. Are all production/inventory cost categories considered (Step 1)?
   b. Are the production/inventory costs categorized correctly (Step 2)?
   c. Are the percentages used for the mixed service costs reasonable (Step 2)?

The regulations also provide for an elective method of computing the mixed service costs that will be allocated to production/ inventory activities. This "simplified service costs method" is not frequently used by garment manufacturers. Its application is described in detail at Treas. Reg. section 1.263A-1(h).

Step 3 -

The third step takes the total indirect costs (100 percent production/inventory column + the final mixed service costs column) and determines how much of the total must be allocated to the ending inventory. Most manufacturers use the "simplified production method" to make this allocation. Treas. Reg. section 1.263A-2(b) prescribe the

Total IRC section 263A Costs @

------------------------------ = Absorption Ratio

Total Production Costs #

Absorption Ratio X Production Costs in Ending Inventory* = IRC section 263A costs to add to Inventory

@ = 100 percent production/inventory column + the final mixed service costs column.

= IRC section 471 costs incurred during the taxable year. In other words, the "already in inventory" column.

* = Ending inventory before considering IRC section 263A.

An observation about inventory that is properly valued below cost:

– Treas. Reg. section 1.263A-1(a)(3)(iv) provides that IRC section 263A does not apply to inventories valued at prices actually offered to customers. However, IRC section 263A does apply to inventory valued at replacement or reproduction cost.

Some manufacturers make no separate calculations for an IRC section 263A amount to add to ending inventory. They point to a "miscellaneous" cost entered on each cost sheet (for example, 50 cent/unit or $1/unit) and contend that this is an overhead factor that has the same effect as making a separate IRC section 263A calculation. There are usually no work papers to identify the cost categories and computations supporting these "miscellaneous" additions. Another problem is that the piece goods and work in process segments of inventory have been incorrectly omitted from UNICAP consideration.

An examiner facing this situation should make an independent IRC section 263A calculation. From the amount to be added to inventory, then reduces the adjustment by:

- Overhead dollar amount x Units of finished goods containing that overhead factor.

Chapter 8

EXPENSE ACCOUNTS

TRAVEL

Travel expense will usually be a significant amount, especially if the manufacturer's sales department relies on employee salespersons, as opposed to independent sales representatives. Manufacturers send sales personnel to various trade shows across the country, as well as to customer locations to solicit orders. In addition, market weeks and customer goodwill considerations will constantly keep the sales staff on the road.

Production department personnel will also travel to initiate/maintain piece goods sources, or to maintain a level of quality control over the goods produced away from the immediate area by both domestic and foreign contractors. Design personnel may also travel overseas.

The issues, of course, are whether all travel is "ordinary and necessary" within the meaning of IRC section 162, and whether travel expenses have been documented as prescribed by IRC section 274.

Accounting for Travel

Manufacturers account for travel expenses in several different ways. Some use a combination of methods.

One method involves direct reimbursement of travel costs incurred by an individual. The traveler keeps track of the travel expenditures, submitting receipts, invoices, airline tickets, etc. to the employer and obtaining direct reimbursement (or offsetting an advance and remitting the difference). If this method is followed, per Treas. Reg. section 1.274-5(e)(4) and Treas. Reg. section 1.6041-3(i), no information return would be required if the expenditures equaled the reimbursements. However, the travel expenses would still need to be substantiated per IRC section 274(d).

A variation of this method involves major expenses (airfare and lodging, for example) being billed directly to the manufacturer. The traveler pays for other expenses such as meals, entertainment, taxi fares and requests reimbursement of the latter expenses.

If the individual is advanced or reimbursed with a flat dollar amount, regardless of the amount of expenditures incurred, that is, there is no accounting to the employer, then the reporting requirements are different. In this case, the reimbursements are subject to the information reporting requirements of IRC section 6041 and the total amount of reimbursements must be included on Form W-2 and the full reimbursement is subject to employment taxes. Excess expenses would be subject to the 2 percent adjusted gross income limitation and require itemizing deductions. The manufacturer would simply deduct the entire amount of the allowance.

Another method of accounting for travel involves supplying individuals with company credit cards. Often, a corporate shareholder/officer and key employees will have a credit card for travel and other uses. Purchases of samples, entertainment of clients, and miscellaneous company expenses may be charged on the credit card.

Reimbursements/allowances paid under a "nonaccountable" plan are subject to employment taxes on the total amount paid. Excess payments under an "accountable" plan are also subject to employment taxes. For a complete discussion of employment tax consequences of reimbursements/allowances, refer to:

- Treas. Reg. section 1.62-2(h)
- Treas. Reg. section 31.3401 (a)-1
- Treas. Reg. section 31.3121(a)-3
- Treas. Reg. section 31.3306(b)-2
- Rev. Proc. 91-67
- Rev. Proc. 92-17
- Rev. Proc. 92-104

AUTO EXPENSES

A manufacturer may own vehicles ranging from autos to vans to trucks. Some vehicles may be used to deliver goods to a contractor or to pick up goods from a local textile mill. These expenses may be allocated among production, sales, and administrative costs.

The accounting for auto expenses is different for each entity. Sometimes the corporation provides a company auto to shareholders and selected employees. Expenses incurred such as fuel, maintenance, insurance, and upkeep will be paid by the corporation. In other cases, auto expenses incurred for employees' or shareholders' own vehicles may be reimbursed by the corporation. Reimbursements may be for actual expenses or in the form of a periodic allowance. The method employed by the corporation will determine whether the reimbursements should be included in the employee's Form W-2.

Accounting for Auto Expenses

When an employer provides an automobile to an employee or shareholder, the taxable consequences will depend whether the vehicle use is excludable as a "working condition fringe benefit." See Treas. Reg. section 1.132-5.

When an employer-provided auto is includible in an employee's income, the value of the personal portion may be determined under the general valuation rule or one of three special valuation rules provided by the regulations (lease value rule, cents per mile, and commuting valuation rule.) The above rules are explained as follows:

1. General Valuation Rule: (Treas. Reg. section 1.61-21(b)) Basically states that the value to be used is the amount that an individual would have to pay for the particular fringe benefit in an arm's length transaction.

2. Lease Valuation Rule: (Treas. Reg. section 1.61-21(d)) This may be used if the auto is supplied for an entire calendar year and will only apply to automobiles or other vehicles for use on public streets, roads, or highways. This rule allows an individual to use the fair market value of automobile as of the first date it was made available to any employee for personal use by referring to a table value. The table value is then multiplied by the fraction of the total mileage driven by the employee that is devoted solely to personal purposes to arrive at the amount includible in the employee's income.

3. Cents-per-mile Method: (Treas. Reg. section 1.61-21(e)) The use of this method is only permissible for vehicles which are used in a selected manner and must be driven a certain number of miles during a calendar year and must not have a fair market value greater than $12,800 as of the date first made available to the employee.

4. Commuting Valuation Rule: (Treas. Reg. section 1.61-21(f)) This rule can be used when an employer provided vehicle is supplied to an employee, and it is not available to the employee for personal use other than commuting. Under this rule, an employee, other than an officer or shareholder owning 1 percent or more, may value the use of the vehicle $1.50 per one-way commute for each time the vehicle is used for commuting.

In these cases where personal use of an auto is includible in an employee's income, that fringe benefit is also subject to employment taxes and withholding per IRC sections 3101, 3111, 3301, and 3402.

Expense Reimbursements Versus Auto Allowances

Reimbursements are sometimes paid when business use of an employee-owned auto is required. The policy of the employer determines whether the reimbursements are includible in Form W-2 and which party will be ultimately responsible for substantiation.

When an employee is required to account to his or her employer and does so properly, the advances or reimbursements equal to the expenses need not be reported on an information return per Treas. Reg. section 1.6041-3(i). This, however, does not preclude the employee from having to report any excess advances or reimbursements over expenses in his or her income.

If, however, an employee is reimbursed on an allowance method under which he or she receives a periodic sum and does not account to his or her employer, then this reimbursement is subject to information return reporting and the employee is responsible for substantiation of any transportation expenses.

Reimbursements/allowances paid under a "nonaccountable" plan are subject to employment taxes on the total amount paid. Excess payments under an "accountable" plan are also subject to employment taxes. For a complete discussion of employment tax consequences of reimbursements/allowances, refer to:

- Treas. Reg. section 1.62-2(h)
- Treas. Reg. section 31.3401(a)-1
- Treas. Reg. section 31.3121 (a)-3
- Treas. Reg. section 31.3306(b)-2
- Rev. Proc. 91-67
- Rev. Proc. 92-17
- Rev. Proc. 92-104.

Leased Autos

For the lessee of an auto which is "listed property," he or she is subject to certain limitations in regards to lease deductions if they are claiming the vehicle is being used for business purposes. Specifically, IRC section 280F(c)(2) states that deductions for rentals or other payments under a lease which exceeds 30 days are only allowable to the extent of the "applicable percentage" of the lease payments, and, as enacted, the statute directs the Treasury to prescribe tables reflecting the "applicable percentage."

These tables, however, do not directly reduce the lease payments. Instead, a lessee is required to include annually in his or her income an "inclusion amount," effecting an indirect reduction of his or her otherwise allowable annual deduction for his or her lease payment. The temporary regulations also require a one-time inclusion in the income of the lessee in the first taxable year that the automobile is not predominantly used in a qualified business use. Note that these tables in the regulations should not be confused with the Annual Lease Value Tables used to compute the amount of income includible in an employee's income for use of an employer provided automobile.

ENTERTAINMENT

As originally enacted with the Tax Reform Act of 1986, IRC section 274(n) provided for an 80 percent limitation on deductions for entertainment expenses, that is, a 20 percent disallowance. The Omnibus Budget Reconciliation Act of 1993 subsequently changed the limitation to 50 percent, that is, a 50 percent disallowance. Thus, entertainment expenses incurred in taxable years beginning before January 1, 1987, are fully deductible. Entertainment expenses incurred in taxable years beginning after December 31, 1986, and before December 31, 1993, are 80 percent deductible. Entertainment expenses incurred in taxable years beginning after December 31, 1993, are 50 percent deductible.

This expense may be reclassified in any number of accounts such as promotion, selling expense, dues, gifts, or others. The expense is usually not screened by a bookkeeper or accountant and, therefore, may be classified incorrectly. This is important since accountants will simply take the balance of the "entertainment" account and reduce that amount by 50 percent to comply with the limitations of IRC section 274(n). However, business meals and other entertainment expenses may be included in other accounts as well. Similar to the travel expenditures mentioned above, entertainment expenditures are subject to the substantiation requirements of IRC section 274(d).

SALARY DEDUCTIONS AND ACCRUALS

A standard payroll reconciliation of wages from Form 941 to the salaries/wages on the income tax return may provide the examiner with an audit lead. Unreconciled amounts may be due to the following:

1. Amounts booked as salaries and wages but paid out of a general disbursement account, with no employment taxes or withholding deducted. Extraordinary payments such as bonuses may be paid out of the general disbursement account, thereby avoiding the payroll taxes and withholding.

2. Officer salaries may include reclassifications of a loan account. Although FICA and FUTA limits may have already been reached through regular salary payments,

a remaining issue might be whether the loan reclassification amounts were included in the individual's Form W-2. This omission is especially possible in an automated system since the only information that usually gets on to a Form W-2 statement is information that flows through the payroll processing.

IRC sections 267 and 404(a)(5)

When a corporation accrues a year-end salary amount for one or more of its officer/shareholders, IRC section 267(a)(2) may prevent a current tax deduction. Under IRC section 267(a)(2), a deduction is allowable only when the item is includible in the gross income of the recipient, provided:

1. The amount is not includible in the gross income of the recipient until paid because that person uses the cash method of accounting, and

2. The payer and the recipient are related persons described in IRC section 267(b) at the close of the taxable year for which the item would otherwise be deductible.

Before IRC section 267 can be applied to disallow a deduction, the officer-shareholder must actually or constructively own more than 50 percent of the value of the outstanding stock. If he or she owns 50 percent or less of the outstanding stock and IRC section 267 cannot be applied, then IRC section 404(a)(5) should be considered.

IRC sections 404(a)(5), 404(b)(1), and the corresponding Temporary Treas. Reg. section 1.404(b)-1T address deferred compensation arrangements. Except for brief deferrals of 2-1/2 months or less, compensation paid under any "method or arrangement" providing for deferred benefits is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount is includible in income (with very narrow exceptions). The recipient need not have any ownership interest in the manufacturing entity.

IRC section 404(d) contains a similar restriction for payments to independent contractors.

OTHER EXPENSES

Gifts

This is a common expenditure and the $25 limitation per individual is often not followed. Accounts where gifts might be deducted include samples, entertainment, and promotion expense.

Sample Expenses

Manufacturer employees sometimes purchase clothing at retail to adapt a design or construction feature of the article to a style being developed. This is especially true for manufacturers who "knock off" other garments as a general practice. However, as with entertainment expenses, these expenditures are rarely screened for their allowability and personal expenditures are often identified in this account. For example, personal purchases of shoes, jewelry, garments unrelated to the manufacturer's product line might be deducted in this account. Careful examination of these items should be made since receipts are seldom descriptive.

In addition to the retail definition described above, "sample" has other meanings:

1. Small quantities of piece goods that are purchased in the course of deciding between fabrics, patterns, and colors for specific styles.

2. Pre-production one-of-a-kind garments assembled to test a variety of fabrics, colors, assembly techniques, etc.

3. Duplicates, or selling samples, supplied to sales personnel to show customers.

Of the four different uses of "sample," the retail purchases context is that which most often contains questionable deductions. If adjustments are made in this area, they are normally for nonbusiness purchases by owner-employees.

Factoring Expenses

The major factor expenses are interest expense paid on advances and a factor commission. The interest charged can be quite substantial since the rate is usually 2-3 points above the prime rate, and advances can be quite large. The commission expense is commonly 1 to 1-1/2 percent of factored sales. These expenses can be verified easily by examining monthly factor statements.

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Chapter 9

INFORMATION RETURNS & BACKUP WITHHOLDING

GENERAL BACKGROUND

Entities which operate a trade or business and make payments of rent, salaries, wages, and other compensations of $600 or more for a calendar year are required to file information returns to report such payments (IRC section 6041(a)). These returns are one means of encouraging sewing, cutting, and other independent contractors to report income accurately and timely on their income tax returns.

The audit inquiries are as follows:

1. Did the manufacturer file all required Forms 1099?

2. For the Forms 1099 that were filed, was all information complete and accurate (payer's identity, payee's identity, amount paid)?

The subsequent sections will include a summary of the penalties applicable to manufacturers' failures to file Forms 1099, and to their failure to include complete and correct information on the Forms 1099.

The two areas of concentration for Form 1099 compliance are payments for services to sewing, cutting, and other production entities and commission payments to salespersons. Although the audit steps are similar, they are divided into two sections due to slightly differing issues.

AUDIT TECHNIQUES

These techniques are only a general guide, since the exam techniques for a specific taxpayer will depend in part on the types of records maintained and the degree to which the taxpayer's accounting records are computerized.

Sewing and Cutting Contractors

During the required filing checks audit phase, the Form 1096, Transmittal Form, and Form 1099, Information Returns Form, should be secured for the calendar years that span a fiscal year being examined. Any schedules used to prepare the Form 1099 statements should also be secured, to expedite audit work. The best schedules will have the dates and check numbers listed as well as the amounts.

To test the accuracy of total amounts reported on filed Forms 1099:

1. The total number of statements filed per the Form 1096 transmittal and the Form 1099 statements should be compared with a PMFOL summary. Agreement with the PMFOL provides some assurance that the items presented are copies of what was actually file.

2. If a payment schedule has been provided, compare the amounts on the schedules for selected contractors against the amounts on the Form 1099 statements prepared. Do not assume the Forms 1099 will automatically agree with the payment schedule. In one case, payments for selected contractors had been included on the schedule but no Forms 1099 were ever prepared.

3. To determine the completeness of the Forms 1099 select a few contractors and compare the payment schedules with the cash disbursement journals for the related calendar year.

4. If there are any doubts about the actual filing of the Forms 1096 and 1099, a listing of Forms 1099 filed by the payer can be secured with an IDRS request using IRPTR-R.

5. Even if no detail payment schedule is available, one can still perform accuracy and completeness checks. Select certain contractors and schedule out the disbursements from the related cash disbursement journals. Although this step will take some time, it is the only means of gauging the accuracy of the Form 1099 statements.

To test for unfiled Forms 1099:

-- Scan the A/P or cash disbursement journals for payments classified into contract labor accounts. Note any contractors whose payments did not appear on the payment schedule or the Form 1099 statements. Ascertain the reasons why the manufacturer did not prepare a statement. If it's claimed that the contractor is exempt due to corporate status, the manufacturer should be asked for the documents upon which it based its determination such as a written statement from the contractor, Form W-9, copy of state registration certificate.

IDRS research can help the examiner to verify whether or not a particular contractor is a corporate entity. Any identifying information that the manufacturer supplies will speed the research; copies of Forms W-9, for example, should be solicited. An available payee TIN would enable the examiner to request an INOLE, which would likely identify the type of entity assigned the TIN by virtue of the types of returns required. At worst, the INOLE would provide additional cross reference information with which to expand the research. Even if the only information available about the contractor is the business name and address, however, this would still be sufficient to make an EINAD or a SSNAD search on IDRS, which in turn would lead to a TIN on which to request an INOLE.

States requiring registration of garment companies may also provide valuable information with which the examiner could distinguish corporate entities from non-corporate ones. For example, the state of California maintains a database of all registrants, and this database has been consulted innumerable times for just such inquiries.

Nonfiled Forms 1099 for non-corporate entities may be subject information returns penalties. They may also suggest the existence of back-up withholding issues, which have even greater tax consequences for the payer. Back-up withholding is discussed in detail in subsequent pages.

To test the accuracy of the payer's and payee's identification:

-- The Forms 1099 should also be examined for incomplete or inaccurate identifying information. Both the payer's and payee's complete name, address, and Federal TIN are required; the emphasis is on identifying missing or obviously incorrect data. Special attention is paid to payees' identification. Accurate payment reporting on Forms 1099 allows the Service to conduct compliance checks on the recipients, such as by matching IRP data with filed returns and by making inquiries of filing requirements when IRP transcripts indicate a potential non-filer. Payee TINS are, therefore, very important considerations.

Sole proprietors' proper TIN has been a continuing problem area for payers and payee alike. Prior to September 1, 1990, a sole proprietor's Form 1099 was required to reflect the owner's Social Security number and the owner's name. Technical Decision (T.D.) 8365, effective September 1, 1990, liberalized the requirement. It provided that in conjunction with the owner's name, a sole proprietor could use either its Social Security number or its Employer Identification number. T.D. 8365 clearly stated that the business name alone was not acceptable; the individual name of the business owner must be entered. Although this Treasury decision was written to address backup withholding, its provisions were also reflected on Forms W-9 printed after September 1, 1990, so it also has applicability to information returns.

In addition to information returns penalties, missing payee numbers or obviously incorrect payee numbers (such as a TIN with only six digits) may give rise to back-up withholding issues which would have even greater tax consequences for the payer. Back-up withholding is discussed in detail in subsequent pages.

Commissions for Sales Personnel and Other Independents

Manufacturers often use independent sales representatives to sell their lines. The following audit steps are suggested:

1. Follow the same steps as above. In addition to a payment schedule, a separate worksheet may be maintained for each salesperson which would list the commission percentage and the sales per week or month.

2. Also note whether checks are being disbursed to sales personnel who do not appear on a commission schedule or disbursement schedule. This may represent reimbursements of some sort for which a separate Form 1099 statement should have been prepared.

Other Issues

Any names on Form 1099 which also appears on payroll information such as Forms W-2 and payroll journals indicate an issue. Company employees are sometimes paid separately for additional or specialty work. These type of payments are subject to employment taxes since the worker is still operating as an employee rather than an independent contractor.

INFORMATION RETURN PENALTIES

Information Return Penalties: IRC sections 6652, 6676, 6678, and 6721-6724

When manufacturers pay non-corporate independent contractors for services, the payer may be required to file and furnish Forms 1099 if the reporting threshold has been met. These penalties should be considered if complete and accurate Forms 1099 are not filed. These penalties should also be considered if complete and accurate Forms W-2 are not issued to employees.

1. IRC sections 6652, 6676, and 6678 -- For returns and statements the due date for which (determined without regard to extensions) is on or before December 31, 1986.

   IRC section 6652 imposes a penalty for failure to file certain information returns and other statements. The penalty under IRC section 6652 is increased if the failure is due to intentional disregard of the information reporting requirement. IRC section 6676 imposes a penalty for failure to supply taxpayer identification numbers. The IRC section 6676 penalty applies to situations where the manufacturer fails to include his Taxpayer Identification Number on a Form W-2 or Form 1099, or the payee fails to furnish a taxpayer identification number to the manufacturer. IRC section 6678 imposes a penalty for failure to furnish certain payee statements (for example, for failure to furnish a Form W-2 to the employee).

2. IRC sections 6721, 6724, and 6676 -- For returns and statements the due date for which (determined without regard to extensions) is after December 31, 1986, but on or before December 31, 1989.

   IRC section 6721 imposes a penalty for failure to file certain information returns. IRC section 6722 imposes a penalty for failure to furnish certain payee statements. IRC section 6723 imposes a penalty for not including all of the required information (or for inclusion of incorrect information on an information return or on a payee statement). IRC section 6724 sets forth the definitions and special rules with respect to the information return penalties. The penalties under IRC sections 6721 and 6723 are increased if the failure is due to intentional disregard of the information reporting requirement. IRC section 6676 imposes a penalty for failure to supply taxpayer identification numbers. If a penalty is imposed under IRC section 6676, a penalty cannot be imposed under IRC section 6723(a) or (b).

3. IRC sections 6721, 6724 -- For returns and statements the due date for which (determined without regard to extensions) is after December 31, 1989.

   OBRA 1989 revised IRC sections 6721 through 6724. As revised, IRC section 6721 imposes a penalty for failure to file an information return and for failure to include all required information on the information return (or for inclusion of incorrect information. IRC section 6722 imposes a penalty for failure to furnish a payee statement and for failure to include all required information on the payee statement (or for inclusion of incorrect information).

IRC section 6723 imposes a penalty for failure to comply with a specified information reporting requirement (for example, failure to include or furnish a taxpayer identification number). IRC section 6724 sets forth the definitions and special rules with respect to the information return penalties. The Penalties under IRC sections 6721 and 6722 are increased if the failure is due to intentional disregard of the information reporting requirement.

The penalty for an intentional failure to provide all the required information (or for inclusion of incorrect information) should be considered when the examiner finds numerous occurrences which would suggest intentional disregard, such as the following:

1. No payee identification number.

2. Incomplete payee name and/or address.

3. No payer identification number.

4. Incomplete payer identification name and/or address.

5. Wage payments only partially included on Form W-2, because a portion was paid in cash or general account check, and thus not reported for Form W-2 purposes.

INFORMATION RETURNS STATUTE OF LIMITATIONS

Penalties with regard to information returns may have statute considerations governed by IRC section 6501. If a taxpayer is penalized only for not having filed or furnished an information return, the examiner need not concern himself/herself with a statute of limitations because in the case of no return having been filed, the statute of limitations has not started to "run" (IRC section 6501(c)(3)).

However, if the penalty is for filing or furnishing an inaccurate/incomplete information return, the normal 3-year statute of limitations started running from the time the return was filed/furnished. If the statute of limitations must be extended, which form should be used to secure the taxpayer's and Service's agreement as to the extended date?

As of this printing, there was no separate statute extension form designed specifically for information returns penalties. Likewise, the Service has not prescribed specific instructions for extending information returns statutes. Local District Counsels should provide guidance. For example, Los Angeles District Counsel advised its examiners to use Form 872. The "kind of tax" is described with the Code section, for example, "IRC sections 6721 and 6722 penalties." The rest of the form is completed in the normal manner.

BACK-UP WITHHOLDING

One of the compliance tools used in conjunction with information return penalties is the back-up withholding provisions of IRC section 3406. The issue most often arises with payments to independent sewing and cutting contractors. In the past, contractors would not supply their identification numbers, and manufacturers would make little effort to force the contractor's compliance. Consequently, Forms 1099 would be issued without them or Forms 1099 would not be issued. This is normally not a problem with commissioned salespersons.

If a non-corporate entity is subject to back-up withholding and amounts are not withheld, the payer is liable for the tax.

Beginning with reportable payments made after 1983, the payer is required to withhold 20 percent (31 percent for payments on or after January 1, 1993) of such payment unless:

1. The payee was exempt from withholding or

2. The payee has satisfied requirements of IRC section 3406(a)(1) or

3. The payment is subject to some other withholding provision.

The exemption for payees would include payments to corporations, financial institutions, tax exempt entities, governmental entities, and international organizations. Independent contractors will fall under an exempt status only if organized as corporations.

A reportable payment subject to withholding generally follows the criteria for information returns reporting as set forth by IRC section 6041(a), that is, a payment for services to a nonemployee from a trade or business and aggregating $600 or more for one calendar year.

IRC section 3406 as it applies to independent contractors involves two primary criteria: In the case of any reportable payment:

1. The payee fails to furnish his or her TIN to the payer in the manner required OR

2. The Secretary notifies the payer that the TIN furnished by the payee is incorrect then the payer shall deduct and withhold from such payment, a tax equal to 20 percent/31 percent of such payment.

The first step in determining whether back-up withholding should be applied lies in the required filing checks audit steps. All Forms 1099 should be secured as outlined in the previous sections. Back-up withholding will apply and manufacturers who fail to withhold the required amounts will be liable in the following situations:

1. A required Form 1099 was not filed, no TIN was supplied, and no back-up

withholding was deducted and deposited from the contractor payment, or

2. No TIN was obtained, no back-up withholding was deducted and deposited, but a Form 1099 statement was filed anyway, or

3. Forms 1099 were filed, TIN's were made available, no back-up withholding was deducted and deposited after notices were sent to the payer about incorrect TIN's.

The key criterion regarding back-up withholding lies in whether the particular contractor provided the manufacturer with the contractor's TIN. Therefore, inquiries must be made of the manufacturer as to what steps were taken and what was the response regarding any requests. If a TIN was provided to the manufacturer but was simply left off the Form 1099 by accident or the Form 1099 was not filed by mistake, then the manufacturer may not be subject to back-up withholding since the contractor did comply. Evidence which would tend to support a manufacturer's claim that a request was made and complied with would be documentation that it had the contractor's TIN when the payments in question were being made. The examiner may want to request the original documents (not copies) on which the taxpayer discovered the names and TINS of payees. Subsequent inspection and analysis may show that the document are much newer than first represented. In addition to requesting the originals, the examiner may want to interview the taxpayer (not the representative) to test his or her credibility with regard to the specific issue. Even though the manufacturer may not be subject to back-up withholding, they still may be subject to various information return penalties, as discussed above.

Back-up withholding is assessed on the Forms 941 for the applicable quarters of payment similar to employment taxes.

BACK-UP WITHHOLDING -- ABATEMENT CONSIDERATIONS

When income tax withholding is an employment tax adjustment, whether attributable to IRC section 3402 (income tax collected at source) or IRC section 3406 (back-up withholding), IRC section 3402(d) allows abatement of the income tax withheld to the extent that the taxpayer demonstrates that the tax has already been paid.

At the time of this revision, the National Director, Specialist Taxes, issued a memorandum dated March 7, 1995, which transmitted supplemental instructions for IRM 4600 (Employment Tax Procedures) with regard to the relief provided by IRC section 3402(d). The supplement authorizes examiners to accept and consider Forms 4699 at the examination level. This means that properly completed Forms 4669 will result in abateable taxes being netted in the preparation of the audit report.

Previously, the full amount of the additional taxes were first assessed by Service Centers, then Forms 4669 were evaluated by Service Centers to determine the abatement amounts. The memorandum referred to above gives interim instructions, pending development of an Employment Tax Examination Handbook that will be used by all the Service's employment tax examiners (Examination, Collection, EP/EO).

TRUST FUND RECOVERY PENALTY (100 PERCENT PENALTY) STATUTE

If a sole proprietorship or partnership is unable to pay its employment tax (including back-up withholding) liabilities in full, the Service normally looks to the principals for payment. Corporations unable to pay its employment taxes pose a different problem because the liabilities of the corporation do not automatically become the liabilities of the principals. The Service will attempt to collect the withholding taxes (employees' share of FICA, income tax withholding, and back-up withholding) from responsible persons under the authority of IRC section 6672, whose provisions are often referred to as the "100 percent penalty." A typical example of its application follows.

1. Assume the examination includes the Forms 940 and 941 for 1991.

2. Normal statute for 1991 Form 940 - January 31, 1995.

3. Normal statute for 1991 Form 941 - April 15, 1995.

If the Service is unable to collect from the corporation and must look to IRC section 6672, only a portion of the Form 941 taxes are potentially collectible, that is, employees' share of FICA and income tax withholding (whether from wages or as back-up withholding). Absent a statute extension, the taxes must be assessed against "responsible persons" under IRC section 6672 by April 15, 1995. A corporate statute extension on Form SS-10 does not extend the IRC section 6672 (100 percent penalty) statute.

For any corporate Form 941 case where the corporation cannot pay the additional employment taxes, if the collection officer is assigned the case after April 15, 1995, he or she will not be able to collect any amount, and he or she will have no opportunity to collect from "responsible persons." The 100 percent penalty statute will have expired.

Whenever a corporation's Forms 941 are adjusted in audit and the tax is unpaid at the conclusion of the audit (agreed or unagreed), the examiner should protect the IRC section 6672 statute by having all "responsible persons" sign statute extension Forms 2750. The extension date would be December 31 of the year following the year in which the statute period will expire (IRM 4684). In the above example, the "extended to" date for the 1991 Forms 941 would be December 31, 1996.

A potentially "responsible person" may refuse to sign a Form 2750, in which case the full amount of the IRC section 6672 penalty would be assessed against that person to protect the Government's interest (after the employment taxes are first assessed against the corporation).

IRM 4684 provides a procedure for examiners to follow if the 100 percent penalty is considered while the case is still in the examiner's possession. It involves making a 100 percent penalty referral to the Collection Division. Local procedures may alter or completely supersede the IRM guidelines.

NOTE: As this revision was being completed, Chief Counsel had advised that the Internal Revenue Code imposes no assessment statute of limitations for the Trust Fund Recovery Penalty. If the Service prevails in a case currently in litigation because of the Trust Fund Recovery Penalty, new procedures will be issued.

GLOSSARY

The words included in this listing are those that are likely to arise in the audit of a garment manufacturer or contractor. Explanations of terms are made in this specific context.

ADVANCE --Partial payment made by a manufacturer to a contractor before the contracted goods are completed. The advance is a short term, non-interest bearing loan from the manufacturer to the contractor.

ANTICIPATION -- A discount based on prevailing interest rates that may be taken on a factored invoice paid prior to the due date. Once common, many invoices now bear the legend "no anticipation allowed."

BUNDLING -- The process of tying together like pieces of fabric, after they have been cut, in preparation for moving them to the sewing operation. The same as "strapping."

CHECK CASHIER -- A business that exchanges currency for a check. They range in size from single outlet operations to chains that have outlets in many neighborhoods. A fee, based on the amount of the check, is charged to the person presenting the check. A check cashing business may be part of other types of businesses, such as markets and convenience stores.

CMT CONTRACTOR -- Cut, Make, and Trim (CMT) contractors provide all cutting and sewing services and supply trim and findings under a single contract for manufacturer.

COLLECTION -- All of the styles produced for the same selling period by a clothing manufacturer for a specific label. The same as "line."

CONTRACTOR -- An entity that performs a designated operation in the manufacturing process, under contract with a manufacturer. A contractor does not have legal title to the goods. The contractor is paid a negotiated amount per piece or per dozen, it maintains its own work force, provides its own machinery and equipment, and secures its own facility.

CONVERTER -- An entity that knits or weaves fabric or adds color or design to fabric.

COST SHEET -- Also called "spec sheets," "calc sheets," or other, similar names. This document lists the quantity and cost of the fabric, freight, trim, labor, and incidental materials such as labels, hangers, and tags required to produce a garment in a specific style.

CUSHION -- A term used by some manufacturers to describe a fixed amount added to their production cost estimates to ensure their expected margin will be achieved if actual costs exceed projected costs.

CUT -- The process of cutting fabric into the shapes required by a pattern. Also refers to a "batch" moving through the manufacturing process.

CUT NUMBER --A number assigned by a manufacturer to identify a specific quantity of fabric from the time that it is segregated to be cut, through all the manufacturing processes, until the finished garments have been inspected by the manufacturer. A cut number is used in conjunction with a style number, so that any "batch" of goods moving through the manufacturing process is tracked by its cut and style numbers.

CUTTING TICKET --A document generated by the manufacturer, which is the primary means of tracking goods through the manufacturing process. Some of the critical information included on a cutting ticket is: Identification of the fabric and its quantity, the style number of the garments to be produced, the cut number assigned to the particular "batch" being placed in process, the cutter who will cut the fabric, the contractor who will assemble the garment, completion dates for the contractors, and number of units for each size.

DUPLICATES -- Small production runs, usually to produce the garments that will be shown by salespersons.

FINDINGS --Items that are essential to the construction of the garment in a structural sense, such as zippers, fasteners, and pads.

FUSING --Bonding of fabrics by means of adhesive and heat for the purpose of helping a garment retain its shape.

GRADING --The process of producing consecutively sized patterns from a sample sized pattern.

GREIGE GOODS -- Woven or knitted piece goods prior to dying or bleaching.

HOMEWORKER -- An individual who performs specific functions in the manufacturing process (such as sewing or pressing) away from the employer's facility, and who also meets the "statutory employee" guidelines of IRC section 3121(d)(3).

JUST IN TIME -- A philosophy or method for decreasing delivery, manufacturing, and warehouse time required to produce finished garments. Successful projects have involved close cooperation between retailer, manufacturer, and mill, with the purpose of increasing sales and reducing inventory. This is also called "quick response."

KEYSTONE -- Keystoning is a standard practice for establishing the retail price of a garment by doubling the retailer's cost. A keystoned $15 (wholesale) shirt will probably bear a $29.98 retail price tag.

KICKBACK -- The rebate of a portion of the price paid for materials or services to the purchaser or to his/her agent.

KNIFE/KNIFE TRIMMER -- A blade attached to overlock and sew overlock machines to trim approximately 1/8 inch from the seam allowance during the stitching process.

KNOCKOFF -- A less expensive version of an original using less costly materials and construction. Usually achieved by purchasing the original garment, taking it apart, and copying the resulting pieces on paper to produce a sample pattern.

LINE -- All of the styles produced for the same selling period or season under a manufacturers label. The same as "collection."

LOT NUMBER -- This may be used by some manufacturers to designate a style number. More often it is used to identify a fabric in inventory.

MANUFACTURER -- The entity that coordinates all aspects of garment production and that sells the garments to retailers. Among the production functions are designing the garment, securing all components that will make up the finished garment, cutting the fabric, and assembling the garment. Cutting and assembly are examples of operations that are often completed by another entity under contract with the manufacturer.

MARGIN -- The amount by which the wholesale selling price exceeds the manufacturer's cost. This is usually expressed as a percentage of cost. The same as profit margin.

MARKDOWN -- A reduction to the cost of raw materials or finished goods carried in inventory or to the usual selling price of finished goods.

MARKER -- A large rectangular piece of paper that designates the placement of pattern parts on fabric that is to be cut. A range of sizes will be included on one marker.

MARKING AND DRILLING --Making tiny slashes and drill holes in cut fabric to assist sewing personnel in garment construction.

MARKUP -- The amount by which the retail selling price exceeds the retailer's cost. If cost is doubled to arrive at the retail price, the markup is claimed by some to be 50 percent while others view it as 100 percent. A manufacturer will generally refer to his or her price setting practices as profit margin.

OUT THE BACK DOOR — The term used to describe sales made off the books of the company

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PIECE GOODS -- Fabric purchased by the manufacturer.

PIECEWORK -- A method of compensation based on the number of units completed by an employee. This also describes a method of garment production (as opposed to "whole garment" construction).

PIECEWORK TICKETS -- Affixed to bundles of cut goods, these designate the rate at which compensation will be paid and the number of units in each bundle. As the bundles move through the assembly process tickets are removed by the employee completing each process. The tickets are then tallied to determine the number of units completed by each employee, and thus, how much the employee will be paid.

PRIVATE LABEL -- The label used by a retailer who may request that it be substituted for the manufacturer's own on goods delivered to him or her. This is typical of large mail order companies and some department stores.

PROFIT MARGIN -- The amount by which the wholesale selling price exceeds manufacturing costs. This is usually expressed as a percentage of cost. The same as "margin."

QUICK RESPONSE -- A philosophy or method for decreasing the delivery, manufacturing, and warehousing time required to produce finished garments. Successful projects have involved close cooperation between retailer, manufacturer, and mill with the purpose of increasing sales and reducing inventories.

REGISTRATION CERTIFICATE -- This is also referred to as "State Registration Certificate" or "Montoya Certificate." It is a form issued by the State of California to signify that the entity has complied with the annual registration requirements imposed on all entities engaged in garment manufacturing. The certificate must be displayed at the place of business. Each certificate contains an entity's unique identification number which should not be confused with the entity's Federal or State tax identification numbers, though the format is similar.

RN NUMBER -- A registration number assigned to a manufacturer by the Federal Trade Commission. It is often printed on a tag that is sewn into garments, in the format "RN 12345." Its predecessor was the WPL number (Wool Products Labeling).

SAMPLES -- Pre-production, one of a kind garments sewn for the manufacturer to test a variety of fabrics, colors, assembly techniques, etc. Frequently made by the manufacturer, but sometimes contracted out. The term may also be used to describe design samples (finished goods purchased to copy or adapt), and selling samples.

SEASON -- A particular time frame for the production and sale of a collection of styles. The primary seasons are fall (also called "back to school" by children's manufacturers), spring, resort (also called holiday or winter), and summer.

SPONGING -- The process of treating piece goods with moisture and heat prior to cutting. Usually only done by manufacturers of high quality lines using expensive, imported silks and woolens.

SPREAD -- Refers to the stack of piece goods prepared for and awaiting cutting.

SPREADING --The process of laying out fabric in layers, in preparation for being cut into the shapes dictated by the marker.

STRAPPING --The process of tying together like pieces of fabric, after they have been cut, in preparation for moving them to the sewing operation. The same as "bundling."

STYLE NUMBER -- A unique number assigned by a manufacturer to each style, to distinguish it from others produced during the current or previous seasons.

SUBCONTRACTOR -- An entity that secures work from a contractor, often when the contractor needs help in meeting a deadline for completion of garments, or when the contractor cannot perform a specialized process in the assembly of the garment.

VERTICAL OPERATION -- This term describes an enterprise that begins with raw fiber, spins the yarn, knits or weaves the greige goods, dyes, then cuts and sews the goods into finished garments. Common in Europe, vertical operations are rare in the United States, but do exist, mainly in the knitted apparel business.