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Some Aspects in Accounting for Manufacturers Employing Contractors

By Julius D. Kahn

The manufacturing portion of the garment trade is concentrated to a great extent in large cities. This immense industry is not monopolized by a few large concerns but is composed rather of many small and medium-sized businesses. Because of the many intricate problems involved in each function of producing a finished product, and because of mass production required, specialization in industry is becoming common, so that practically all the larger manufacturers are turning over the production part of their business to contractors. These contractors perform merely the necessary processes to convert raw materials into a finished product.

By employing contractors, the manufacturer is benefited in many ways, especially where all the functions of operating the business are under the control of the proprietor. It enables him to concentrate more upon the important question of distribution of his product; to devote more energy toward purchasing the raw materials of latest designs at the lowest prices compatible with quality; it enables him better to finance himself by avoiding large investments in plants and by eliminating waste due to idle equipment and the carrying of "key" operators through slack periods; it enables him to avoid controversies with labor unions, as he can employ out-of-town contractors where conditions may be more favorable to him; and in some instances he can obtain the finished product cheaper than if he produced it himself, as contractors specialize in manufacture only and usually work for more than one manufacturer, thereby obtaining all the benefits of mass production by combining the plants of many factories into one. In order to be assured of a minimum amount of production, some manufacturers require at least one contractor to handle their output solely, and to him they give the bulk of their business; or they may limit the number of manufacturers the contractor may serve if the latter desires to retain the business. Being relieved of the details of production, the manufacturer is thus better enabled to coördinate his output with sales orders.

These advantages, however, are not without evils. As a contractor operates on a close margin of profit on labor charges, he may be tempted to employ fraudulent means to advance himself financially. To operate efficiently and prevent any "leaks" in his organization, the manufacturer must protect himself against these fraudulent practices.

To illustrate, the manufacturer may estimate $3\frac{1}{4}$ yards to a garment and compute his costs accordingly. The contractor may endeavor to save cloth by cutting $3\frac{1}{8}$ yards to a garment by skimping or by cutting smaller sizes than ordered. Thus he may return more garments from the materials allotted than the manufacturer contemplated. As a result, the manufacturer will be paying the contractor for these garments additional labor charges, and he will also be paying for his own materials at advanced prices.

The production manager of a medium-sized concern in collusion with certain contractors accepted garments in excess of the quantity charged on order, which operated to the detriment of the company and would have resulted in its ultimate failure had it not been detected in time. The most effective safeguard is the proper installation of an adequate system of internal check, so that only garments in compliance with the style, size, quality and quantity ordered shall be accepted. There are texts on this subject of internal check, and the principles which govern the application of such a system need not be discussed here. One which may be highly commended is *Fraud—Its Control Through Accounts* by George E. Bennett.

On the other hand, the contractor may return fewer garments than were ordered. To avoid this, with its consequent delay in the filling of orders which may be wanted immediately, the manufacturer should make the contractor conscious of his responsibility for loss of materials by charging him for short delivery at prices much in excess of cost.

When the contractor receives cut goods, it is impossible for him to save on yardage. But, he may purchase identical materials cheaper elsewhere and gain by the difference in costs of the raw materials. For example, a manufacturer purchases materials for $3.00 and charges the contractor $6.00, the labor charge to be added upon completion to be $1.50, making a total charge of $7.50 by the contractor for the finished product. If, after using all the materials, the contractor purchases additional goods elsewhere and pays $3.00, the manufacturer is paying $7.50 for a garment which should only cost him $4.50. Again the remedy is a proper system of internal check. To guard against inferior merchandise, there are technical instruments which the piece-goods or production manager can use. For further protection, "swatches" or samples of the prime raw materials consigned should be attached or pasted in a scrap-book according to style numbers, with specifications listed to permit ready comparison with the materials of the finished garments received.

A shipment "on memorandum" is a mutual benefit bailment by which possession of the goods passes but title still remains vested in the manufacturer. The manufacturer can sue the contractor for ordinary negligence only, but he should refuse to accept any garment which deviates to any extent from the specifications so as to prevent the contractor from setting up the defense that by acceptance the manufacturer automatically approved of the quality and workmanship and thereby asserted his willingness to pay for them at the price charged. If the contractor sells the garments elsewhere, the manufacturer may sue for conversion of title. Accordingly, consignments to contractors should be recorded by memorandum entries only and not as ordinary sales to customers. Since title does not pass, the manufacturer should include as part of his inventories the merchandise in hands of contractors at closing dates.

At the termination of his services, the contractor has a lien upon the goods to the extent of his unpaid labor charge, as long as he retains possession of the goods; but, as soon as he returns the finished product to the manufacturer, his lien ceases, and his only remedy for unpaid services is to sue for the value.

If the merchandise is damaged through no fault of either party and before completion of the garments, the manufacturer must compensate the contractor for the labor performed up to the time the goods were destroyed, unless both parties agree to the contrary. The contractor is not responsible for fire or theft unless this occurs through his own negligence. Hence, the manufacturer should insure himself against these contingent liabilities. This question should be given consideration when one is reviewing financial statements of manufacturers who employ contractors.

There are two methods of compensating contractors. The simplest and the one most commonly used requires a flat sum to be charged for each style of garment completed, and the amount is a matter of agreement between the manufacturer and the contractor. This method may work a hardship upon either party during the transitory period from one phase of the business cycle to another, such as the period through which we are now passing. This may cause strikes and other hindrances which retard normal production.

To overcome this, the manufacturer may resort to a second method of compensating contractors: namely, by a certain percentage of the manufacturer's billing prices of the raw materials consigned. The labor cost under this method tends to follow the variations in raw material costs, especially in a fluctuating market, and the manufacturer is better able to regulate the prime cost of his product in accordance with the general trend of business. Under the flat-labor-charge method it is immaterial upon which basis the charge for materials consigned is computed as far as the labor cost is concerned. Cognizance must be taken of the effect of the establishment of the billing price upon the determination of the percentage to be charged. The bases that could be used for billing purposes could be actual cost, present market quotations or any arbitrary amount above or below these figures. Thus 10 per cent. on actual cost would yield the same amount of labor as 5 per cent. upon an advance of 100 per cent. above cost.

Notwithstanding that the labor charge is based upon the price of materials charged, the manufacturer must still beware of overshipments; otherwise, he will be paying a greater percentage of the materials charged than that which was predetermined. This is so because the contractor bills by number of garments completed rather than by yardage.

Remittances to contractors should be accompanied with remittance statements to indicate the details of payments. If the contractor's invoice includes a countercharge for the raw materials consigned, the manufacturer must deduct his charges for raw materials shipped, to ascertain the net labor charge to be paid. This is avoided where the contractor's invoices are for labor only.

Manufacturers employing contractors deduct a charge for insurance as reimbursement for premiums which they pay covering loss of merchandise consigned under floater policies. The rate charged is purely arbitrary and usually excessive (generally one per cent.), established more or less by custom and not in accord with the basis used by insurance companies. The sum of insurance which it yields varies in direct relation to the volume of finished goods. The rate used may be computed upon either of the following bases, depending upon agreement: (1) on the total contractor's charges, which may include materials in addition to labor; or (2) on net labor charges only. Obviously, the second basis will result in a larger remittance.

In my opinion, there is no logical reason for this charge, inasmuch as title to the goods rests in the manufacturer and loss would have to be borne by him. Hence, any deductions taken from remittances to contractors in effect amount to reduced sums which they receive for their services; and, accordingly, the total insurance charges are deducted from the contractor's labor cost in the cost-of-goods-sold section of the profit-and-loss statement.

It is essential that the manufacturer insist that the contractors keep each lot of goods separate or tagged in a particular way for identification purposes, so that their invoices may be prepared for each lot separately as it is completed. This will avoid remitting sums to apply on account until all lots are completed at the end of a season, when disputes almost invariably arise.

The remittance statement accompanying the cheque should cover specific invoices only, reconciled with the subsidiary ledger account and compared with the contractor's statement. This will enable the ledger account to be properly "keyed," so that the final balance in the account will represent specific open items.

Following is an illustration of a contractor's ledger account; which also served as a check upon the quantities of garments shipped and returned, thereby facilitating the preparation of remittances:

CONTRACTOR'S LEDGER SHEET

Contractor ....

Address ....

Date	Lot No.	Styles Shipped #	#	#	Rep.	F. Inv. No.	Dr.	Date	Lot No.	Styles Returned #	#	#	Rep.	F.	Cr.

Where the percentage method of compensating contractors is used, the subsidiary ledger account could be kept more advantageously in yardages rather than in units, as any erroneous overcharges could be more easily detected. Regardless of which method of compensation is used, the manner of recording the contractor's transactions remains unaffected.

The simplest method of handling contractors' transactions upon the books would be to ignore any memorandum entries for the shipment or receipt of merchandise, thereby eliminating the contractors' subsidiary ledger entirely. All payments to contractors for labor performed would be charged directly to "outside labor" through the cash-disbursements book. In journal form the entry would be:

Outside labor	$	
Insurance charged to contractors		$
Cash		$
To record remittances to contractors.		

Any finished garments on the manufacturer's racks at the end of the period, for which no remittance for labor has been made, should be included in the inventory and the accrued labor thereon should be recorded. This information may be derived from the unpaid invoices.

The disadvantage of this method is that no accounts are kept with individual contractors to show a chronological and detailed record of all payments and of balances due. Furthermore, memorandum invoices do not show the amount to be charged a contractor in case he fails to return any raw materials.

For these reasons, under the second method of recording transactions with contractors, entries are made to reflect upon the books the shipment and receipt of merchandise. There is a distinction to be noted in the manner of billing between entire-piece goods and cut-goods consigned. In the former case, the manufacturer charges for each raw material separately when it is shipped at a unit price per yard, gross, dozen or piece, as the case may be; whereas if cut goods are shipped, the manufacturer's invoice is at a price per garment cut, which covers all the raw materials that enter into the fabrication of the garment. Any invoice for linings or trimmings delivered subsequent to the shipment of the cut-piece goods is marked "no charge."

The entries in journal form to record the transactions from the shipment of the raw materials to the final remittance for the finished product, are as follows:

Contractors' accounts payable	$	
Shipments to contractors		$
To record the consignment of raw materials to contractors.		

It is insignificant whether cut goods or piece goods are shipped. The term "shipments" is preferred to "sales."

Purchases of finished goods from contractors	$	
Contractors' accounts payable		$
To record the contractors' charges for finished garments received.		

Contractors invoices may be entered in the regular purchase book, or a separate book may be kept if the volume of work is sufficient to warrant employment of another clerk.

Contractors' accounts payable	$	
Insurance charged to contractors		$
Cash		$
To record remittances to contractors.		

It may be appropriate for a manufacturer who handles two or more kinds of merchandise to use both methods, especially if it is desired to keep separate accounts in the general ledger for each class of article manufactured. The first method may be used to record the outside labor for the minor classification, and the second method for the main one.

Assuming that all the lots of materials shipped are completed and returned, the entries given above would be sufficient accurately and correctly to record contractors' transactions. However, as is usually the case, the ideal situation rarely exists; there is practically always in the hands of contractors some merchandise which may be in the form of raw materials, goods in process or a part of finished garments awaiting shipment—especially during the preseason months. Nevertheless, it has been and still remains the customary practice for some accountants to prepare financial statements based solely upon these entries without further adjustments. The balance in the contractors' accounts-payable controlling account is shown on the balance-sheet as a current asset or a current liability, depending upon whether the balance happens to be a debit or a credit. Because the contractors' controlling account is a mixed account, the following objections arise:

1. Since the shipments to contractors are treated as sales instead of consignments, merchandise at contractors' premises is incorrectly included in the balance of the contractors' accounts-payable account. As the manufacturer retains title to the goods, such merchandise should be included as a part of the manufacturer's inventories and be shown separately.

2. The merchandise at contractors' premises may have been charged at a premium over cost. In that case it should be reduced to cost or cost or market whichever is lower.

3. Other debit items may appear in individual contractors' accounts representing cash advanced in anticipation of labor to be performed in the future, or it may represent an amount due the manufacturer for raw materials or finished garments returned for repair or for other reasons but never reshipped. These items are properly current receivables and should be segregated.

4. Amounts due for labor on completed garments, which are subject to deductions for insurance charges, are also included as a part of the contractors' accounts-payable account and are improperly offset against the merchandise inventory when shown on the balance-sheet. Although the working capital remains the same, the effect upon the working capital ratio is too obvious for further comment. Moreover, this practice conceals from those who read the balance-sheet the true state of the company's affairs.

5. The profit or loss for the period is erroneously stated on the profit-and-loss statement. A false profit appears upon the statement because consignments are treated as ordinary sales. The net contractors' labor cost is misstated, because the merchandise at contractor's premises should be treated in the same manner as other inventories and not as a deduction from the contractors' invoices for finished goods. In addition, the deduction for insurance charges does not include deductions to be taken on finished goods received but not paid for up to the time of closing. Some statements prepared by accountants have shown the net contractors' labor cost as a credit balance. This may occur when there is a large stock at contractors' premises at the end of the period and the "shipments to contractors" account exceeds the "purchases of finished goods from contractors." The profit-and-loss statement is also misstated by the amount of raw

materials in hands of contractors at the end of the previous period which has been closed and improperly omitted from the "shipments to contractors" account in the following period to offset the contractors' charges for the finished goods when subsequently completed.

To eliminate all the foregoing objections which arise under the customary procedure of treating contractors' transactions upon the books and statements, the accounts should be adjusted in accordance with sound accounting principles and practices, so that the balance-sheet may set forth the true financial condition and the profit-and-loss statement may present the actual results of operations. Accordingly, the contractors' accounts-payable account must be analyzed so as to convert a mixed account into its real and nominal elements. For purposes of preparing monthly statements only, the following adjusting entries can be made merely on working sheets and need not be recorded on the books until the end of the fiscal year:

Shipments to contractors	$	
Contractors' accounts payable		$
To reverse memorandum entry set up for raw materials in hands of contractors at billing prices.		
Advances to contractors	$	
Due from contractors	$	
Contractors' accounts payable		$
To transfer other debits representing assets to separate appropriate accounts.		

Note: These debit balances are analogous to debit balances in ordinary merchandise creditors' accounts, and they should be treated alike on the balance-sheet.

Contractors' accounts payable	$	
Insurance charged to contractors		$
Outside labor accrued		$
To close the balance of the memorandum account kept with contractors, representing amounts due for labor, and to record the amount of insurance to be deducted when paid from finished goods already received.		

All these adjusting entries should be reversed at the first of the following period, so that the contractors' accounts-payable controlling account may be reëstablished upon the general ledger to control the contractors' subsidiary ledger.

The inventories remain to be considered. In order to present the complications most apt to occur, it will be assumed that the manufacturer maintains a cutting department and consigns cut-piece goods to contractors. The inventory in the hands of contractors could be taken up in the accounts and recorded in the same manner as the other inventories. Irrespective of what may be the stage of the inventory at the contractors', the manufacturer should record only the cut goods stock, which should be valued for inventory purposes at the sum of the following: (1) at true cost of the raw materials to the manufacturer; plus (2) cutting labor expended on it; plus (3) cutting department overhead applicable to it; plus (4) any cost of transportation, such as freight and handling charges, incurred in shipping the cut goods. The inventory on hand may consist of goods in a raw, partly cut or cut state, which should be similarly valued for inventory purposes, except that the labor and overhead on partly cut goods would have to be apportioned according to stage of progress.

The inventories should appear condensed on the balance-sheet as follows:

Raw materials—on hand		$
Cut goods—on hand	$	
Cut goods—at contractors' premises	$	$
Finished goods—on hand		$
Total inventories (how valued)		$

The reason for ignoring any labor or overhead costs on cut goods at contractors' premises, which may be in process or finished awaiting delivery, is that the manufacturer's accounts on the general ledger do not contain these expenditures. However, anyone reading a balance-sheet of a manufacturer employing contractors should consider the contingent liability for any expenditures incurred upon cut goods by contractors, for which the manufacturer may be called upon to indemnify in case of fire or theft, and also whether insurance is carried to cover this contingency, unless the consignment invoice contained clauses which stated specifically otherwise.

Caution must be exercised to see that all contractors' invoices have been entered during the period under review for all finished goods received during that time.

As a result of adjusting entries, the final credit balance in the "shipments to contractors" account will represent only those raw materials, no matter in what period they were shipped, which have been converted into finished goods in the period under review. The "insurance charged to contractors" account will have a final credit balance which will represent the total insurance deductions on all finished goods completed during the period whether the labor has been paid or not. Consequently, when these accounts are deducted from the "purchases of finished goods from contractors" account in the cost-of-goods-sold section of the profit-and-loss statement, the net difference will have one definite meaning: the true net contracting cost or outside labor cost on all finished garments received by the manufacturer during that particular period.

The quantity of raw materials on hand or with contractors, in addition to piece goods, will have to be estimated from physical stock and by correspondence with contractors, as the sum of the inventory and the work involved to keep a special stock record usually would not warrant the time required.

The quantities thus obtained may then be valued, at actual costs for each respective style number, from the cost binder containing the true detailed costs of each style. If feasible, it would be advisable to take complete physical inventories quarterly, or at least semi-annually, so as to determine the degree of accuracy of the estimated inventories. By preparing monthly financial statements, the manufacturer can keep aware of the progress he is making and guide himself accordingly, instead of waiting until the end of the fiscal year, when it may be too late.

To show the most liquid condition possible, the books should be closed on a date when the inventories, both on hand and with contractors, are at their lowest. However, once the fiscal period has been chosen it can not be changed for tax purposes without the consent of the commissioner of internal revenue. As inventories are not as readily convertible as receivables into cash, and the value is dependent upon an uncertain market, which may vary widely from day to day, the lower the inventory value the more reliance may be placed on the final statement of profits as shown by the profit-and-loss statement.

Since the primary aim in most businesses is profit, the manufacturer should be presented with such facts and reports as will guide him best toward satisfactory results. This may be accomplished by determining the exact production cost of a garment from the production manager and by comparing it with the prevailing selling prices, to determine whether a sufficient margin exists to cover the ordinary business expenses and leave a profit for the owners.

Hence, a separate binder should contain individual cost sheets for each style of garment, showing the true costs to the manufacturer.

Since the selling price of a garment to a customer is the same for all ordinary sizes, only one cost estimate is sufficient for each style. However, for garments of certain specifications not carried in stock, an additional charge, usually of 10 per cent., is added to the established selling price. This is deemed sufficient to cover the slightly additional cost involved in production. The yardage consumed, shown on each cost sheet, should be computed according to the average size of garment sold for each style.

For concerns dealing in low priced garments, where the costs involved for each style are practically identical, merely one cost sheet may be prepared, instead of having separate cost sheets for each style, and the results will be substantially correct. However, where it is necessary to keep separate cost sheets for each style, because of the varying costs involved, statistics should be kept of the quantities of each style manufactured, to be considered in conjunction with the respective cost sheets in order to draw accurate conclusions from the comparison with the profit-and-loss statement.

Following are suggestions of some of the more important uses to be derived from cost sheets, when considered with the profit-and-loss statement, showing actual operations:

1. To determine the degree of correctness of the estimated margin of profit by indicating the efficiency of the production department. This may be accomplished by dividing the number of garments produced into the total cost of each item, as shown by the cost-of-goods-sold section and compared with the estimated costs as shown on the cost sheets. The efficiency of the cutting department, for instance, may be verified from the perpetual stock record sheets by dividing the yardage used by the quantity of garments cut to obtain the yardage consumed per garment. This affords comparison with the pre-determined costs as shown by the cost sheets and with the actual operating results as shown by the profit-and-loss statement. This procedure produces substantially the same results and dispenses with the expensive

cost involved in maintaining an elaborate cost system "tied in" with the general ledger. As the cost sheets may be used to establish selling prices, any marked variations between actual and estimated costs should be investigated. If it is found that the cost-sheets figures conform substantially with the actual costs and an inadequate margin of profit still exists, then, in order to avert possible loss, the selling prices may have to be adjusted, with due consideration given to volume of business and competition.

2. The minimum sales requirement may be estimated, especially where a one-priced product is sold, as a guide to the sales department. Hence, by dividing the estimated average gross profit per garment, as shown by the cost sheets, into the estimated average monthly business expenses, the minimum sales necessary, i.e., the quantity of garments to be sold in order exactly to cover all selling, general and administrative and financial expenses, may be determined. To illustrate, if the average monthly expenses as shown by previous reports, eliminating items not apt to occur in the future, and adjusted in view of probable future circumstances causing any variation, are found to be $20,400, then approximately 30,000 garments ($20,400 divided by $.66, average gross profit after considering the probable volume sold at each price, where various prices are used) must be sold to show neither profit nor loss for the ensuing period. Thus the sales manager can so direct the outlets of distribution to meet at least the minimum sales requirement.

3. The minimum sales requirement is also of value to the credit department, which must coöperate with the sales department in determining whether to adopt a stringent policy and reject all questionable risks or to embark upon a more liberal credit policy in order to reach the minimum amount of sales required. At the same time, the losses due to bad debts must be kept as low as possible.

4. The cost sheets may be used to find monthly profit and loss results where neither physical nor estimated inventories are known.

5. By determining definite costs and establishing a sufficient sales price, a budget may be prepared with greater accuracy, and the business may be better operated. The manufacturer can almost entirely guide himself so as to be adequately prepared to meet any seasonal demands upon the current funds available

much in advance of the time of need. The budget acts as a signal indicating variance between estimated and actual results and compels the management to study and plan for the most economical use of material, labor and expenses.