

§ 1.471-10 Applicability of long-term contract methods.

See § 1.460-2 for rules providing for the application of the long-term contract methods to certain manufacturing contracts.

[T.D. 8067, 51 FR 393, Jan. 6, 1986, as amended by T.D. 8929, 66 FR 2240, Jan. 11, 2001]

§ 1.471-11 Inventories of manufacturers.

(a) *Use of full absorption method of inventory costing.* In order to conform as nearly as may be possible to the best accounting practices and to clearly reflect income (as required by section 471 of the Code), both direct and indirect production costs must be taken into account in the computation of inventoriable costs in accordance with the “full absorption” method of inventory costing. Under the full absorption method of inventory costing production costs must be allocated to goods produced during the taxable year, whether sold during the taxable year or in inventory at the close of the taxable year determined in accordance with the taxpayer’s method of identifying goods in inventory. Thus, the taxpayer must include as inventoriable costs all direct production costs and, to the extent provided by paragraphs (c) and (d) of this section, all indirect production costs. For purposes of this section, the term “financial reports” means financial reports (including consolidated financial statements) to shareholders, partners, beneficiaries or other proprietors and for credit purposes. See also § 1.263A-1T with respect to the treatment of production costs incurred in taxable years beginning after December 31, 1986, and before January 1, 1994. See also §§ 1.263A-1 and 1.263A-2 with respect to the treatment of production costs incurred in taxable years beginning after December 31, 1993.

(b) *Production costs—(1) In general.* Costs are considered to be production costs to the extent that they are incident to and necessary for production or manufacturing operations or processes. Production costs include direct production costs and fixed and variable indirect production costs.

(2) *Direct production costs.* (i) Costs classified as “direct production costs” are generally those costs which are in-

cident to and necessary for production or manufacturing operations or processes and are components of the cost of either direct material or direct labor. Direct material costs include the cost of those materials which become an integral part of the specific product and those materials which are consumed in the ordinary course of manufacturing and can be identified or associated with particular units or groups of units of that product. See § 1.471-3 for the elements of direct material costs. Direct labor costs include the cost of labor which can be identified or associated with particular units or groups of units of a specific product. The elements of direct labor costs include such items as basic compensation, overtime pay, vacation and holiday pay, sick leave pay (other than payments pursuant to a wage continuation plan under section 105(d)), shift differential, payroll taxes and payments to a supplemental unemployment benefit plan paid or incurred on behalf of employees engaged in direct labor. For the treatment of rework labor, scrap, spoilage costs, and any other costs not specifically described as direct production costs see § 1.471-11(c)(2).

(ii) Under the full absorption method, a taxpayer must take into account all items of direct production cost in his inventoriable costs. Nevertheless, a taxpayer will not be treated as using an incorrect method of inventory costing if he treats any direct production costs as indirect production costs, provided such costs are allocated to the taxpayer’s ending inventory to the extent provided by paragraph (d) of this section. Thus, for example, a taxpayer may treat direct labor costs as part of indirect production costs (for example, by use of the conversion cost method), provided all such costs are allocated to ending inventory to the extent provided by paragraph (d) of this section.

(3) *Indirect production costs—(i) In general.* The term “indirect production costs” includes all costs which are incident to and necessary for production or manufacturing operations or processes other than direct production costs (as defined in subparagraph (2) of this paragraph). Indirect production costs may be classified as to kind or type in accordance with acceptable accounting