made to cancel or correct such mark-ups.

(e) In no event shall mark-downs not based on actual reduction of retail sale prices, such as mark-downs based on depreciation and obsolescence, be recognized in determining the retail selling prices of the goods on hand at the end of the taxable year.

(f) A taxpayer (other than one using the last-in, first-out inventory method) who previously has determined inventories without following the practice of eliminating mark-downs in making adjustments to retail selling prices may adopt such practice, provided permission to do so is obtained in accordance with, and subject to the terms provided by, paragraph (e) of §1.446-1. A taxpayer filing a first return of income may adopt such practice subject to approval by the district director upon examination of the return.

(g) A taxpayer using the last-in, first-out inventory method in conjunction with retail computations must adjust retail selling prices for mark-downs as well as mark-ups, in order that there may be reflected the approximate cost of the goods on hand at the end of the taxable year regardless of market values.

§ 1.471-9 Inventories of acquiring corporations.

For additional rules in the case of certain corporate acquisitions specified in section 381(a), see section 381(c)(5) and the regulations thereunder.

§ 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.

§ 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 incident 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.