

# Trickle-Down Effect Of The Sarbanes-Oxley Act On A Privately-Held Seasonal Textile Manufacturer

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## ABSTRACT

*The Sarbanes-Oxley Act (SOX) of 2002 was intended for enforcing accuracy and transparency in the financial statements of publicly held corporations, primarily to protect investors. While it does not directly impact private corporations, we present an indirect effect of SOX related to unsubstantiated deductions by retailers, against a privately-held manufacturer, in the textile industry.*

## INTRODUCTION

Textile manufacturers must be ready to respond to the latest fads and fashion trends. Typically, manufacturers rely on suppliers to provide them quality raw materials at agreed upon conditions, and then sell the finished product to their customers on the terms agreed upon by the customer and the manufacturer.

Small textile manufacturers typically sell to a mix of retailers, from small mom-and-pop shops to large department stores and discounters. Any deviation from the terms of an order, such as in price, fill rate, freight, markdown allowances, co-op advertising and substitutes, results in a chargeback to the manufacturer. This appears as a deduction on the check when the payment is made. While customers usually advise why a deduction has been taken, either before payment is made or as a claim attached to the payment check, prior to Sarbanes-Oxley (SOX) many retailers refused to comply with requests for documentation of deductions. The retailer would account for the additional monies as other revenues, an increase in their gross margin, or use them to reduce their cost of goods sold. The manufacturer would issue a debit memo to their account which would sit on the books for a long time before being written off to bad debt, overstating accounts receivable and negatively affecting their gross margin.

The problem of unsubstantiated chargebacks can be severe enough to put a manufacturer out of business. For instance Saks Inc. was sued for putting an apparel company selling Oscar de la Renta sportswear out of business, after the retailer deducted nearly 35%, or \$31.4 million of the more than \$90 million the company billed Saks (Hogsett, 2005). Internal investigations showed that a division of Saks had falsified information to vendors and "improperly collected markdown allowances from vendors totaling roughly \$20 million between fiscal years 1999-2003" and "another \$8.2 million in markdown allowance had been improperly collected between fiscal years 1996-1998" (Business Wire, 2005). Saks Inc is to reimburse the affected vendors a total of \$48.2 million, including interest at 7.25% annually. Supplementary investigations into other divisions of Saks did not find any over-collections. There was evidence of the improper timing of inventory markdowns reflected in fiscal years 1999 and 2001. Although the improper timing of inventory markdown would affect their quarterly financial statements (overstating gross margins and operating income in some quarters and understating in others), Sak's management believes that it had no effect on their annual financials for the same fiscal years. Chargeback suits have also been filed against Federated Department Stores with plaintiffs requesting class action status (Hogsett, 2005).

The effect of improper chargebacks on Oscar de la Renta were devastating. For small manufacturers, much smaller unanticipated chargebacks can cause severe liquidity crises. The Chief Financial Officer of a small, private seasonal textile manufacturer provided us his opinion on chargebacks and SOX, as it pertains to his company. He requested that neither he, nor the company he represents, be identified.

### **THE SEASONAL TEXTILE MANUFACTURER**

The company sells to large retailers, smaller specialized shops, small sole proprietors, discounters and some Internet stores. They sell internationally and have a website and an Internet store for consumers, as well as a store for general public within their corporate headquarters facilities. The company is a seasonal vendor with variable shipping season, typically beginning around June and ending shortly after Christmas, with heaviest business between late September and Christmas. Sales depend on the weather and the market, and increase with the severity of the cold. Gross margins for the company typically range between 30 and 40 percent. Typically for such companies, once operating expenses, interest and taxes are deducted, net profit ranges from 5 to 12 percent.

### **ALLOWANCES AND UNANTICIPATED CHARGEBACKS**

Based on the initial meetings of their salesperson with the customer, the company anticipates some allowances and builds expected markdowns, defective allowances and co-op marketing into the price of the product. When markdowns are unexpectedly large they request and, for the most part, obtain documentation for verification of any issues. When they are unable to do so, depending on the amount involved, they either keep the open item on the books or write it off to bad debt. Considerations such as the size of the business that the customer brings, and whether the company wants their business next season are very important as to whether the manufacturer accepts the deduction or not.

Customers of the manufacturer usually have vendor manuals, which vendors are required to follow. These manuals discuss many aspects of the mutual relationship between the companies and how they expect their order to be packaged and packed, ticketed and labeled, shipped and invoiced. They also contain offset expense policies that, sometimes, are not very clear. These offset expense policies are normally based on a percentage of the purchase order and may even be broken down to dollars per unit; sometimes both apply. Say a purchase order is valued at \$10,000 for 1000 units. The customer receives the order and discovers that the vendor failed to properly price ticket the units. The customer correctly tickets the order and charges back the vendor for fees and administrative expenses related to the reticketing. The chargeback is calculated at 10% of the purchase order (\$1000) plus \$.25 per unit (\$250) and administrative expenses of \$100. Such chargebacks can add up fast.

Typically unsubstantiated chargebacks relate to vague offset expense policies. For instance manuals may not mention that various violations under the same sub-heading are mutually exclusive, yet the customer may attempt to interpret it that way. Say you ship a product to your customer. You've followed the terms of the agreement so you're expecting to be paid in full. You receive payment to discover that a deduction has been taken. Upon verifying, you discover ambiguity in their offset expense policy. Their policy may reveal 3 different offenses under one sub heading. When you read it, you interpret it differently, as all-inclusive. This is a no-win situation. What happens most of the time is you just absorb it.

The manager recalled a situation a few years back wherein a company they sold took several deductions for violations related to their order and markdowns totaling over \$90,000. They were expecting a check for approximately \$130,000; instead it was for a little over \$37,000. They were in awe; and did not know what they had done that did not conform to the shipping requirements of the customer. Since this was an EDI account, the customer's purchase orders were transmitted to them electronically, their advanced shipping notices and invoices were also EDI. Once the manufacturer dug into the deductions, most of the unsubstantiated violations were related to labeling, but some were ambiguous.

The chargebacks containing ambiguity were the ones that they disputed, based on the fact that under one sub-heading, many violations were listed. Nowhere in the vendor manual or offset expense policy did it state that each violation under one sub-heading was mutually exclusive of others. In a letter to their vendor relations department, they included their findings and supporting documentation of the disputed deductions. They were flat out denied with no reasoning for the denial. One more attempt was made to press the issue but this time, there was no response. It really could have been a lot worse, as in the Saks Inc case.

While verifiable chargebacks alert the company to correct the problem in the future, unsubstantiated deductions only affect the gross margin, and inevitably, the bottom line of the company.<sup>1</sup>

### **REASONS FOR UNSUBSTANTIATED CHARGEBACKS**

To combat the problems the manufacturer has established a tactical team to oversee the order process and to ensure accuracy of electronic information. The tactical team pulls apart the vendor manuals, discusses the steps that need to be taken to ensure requirements of the order will be met and alerts upper management in case of a problem. However, that and good communication between the manufacturer and the customer may not always avoid unanticipated chargebacks.

If the customer is having problems with their numbers, there are internal pressures to improve their results and they need to make them up somewhere. The easiest way for them to do that is to take additional markdowns. It is also not unknown for a company to issue incentives or bonuses for collecting on the most violations in a season. It decreases the cost of goods sold for the customer, increasing their gross margin. One could say it is another source of income.

Usually, issues of a customer going to competitors over disputed chargebacks also comes into play, when the customer has changed personnel. A new recruit may be trying to impress their company by trying to make the vendor bend over backwards to improve their gross margins.

### **THE IMPACT OF SARBANES-OXLEY**

Through the enactment of the Sarbanes-Oxley Act, the SEC is requiring that all publicly traded companies submit an annual report on the effectiveness of their internal controls; to increase their financial disclosures and to swear the disclosures are accurate to the best of their knowledge.

SOX does not impact the CFO's company directly because they were not governed by the SEC. As the manager had indicated, unsubstantiated chargebacks were typically not due to miscommunications. Subsequent to SOX, many customers that would normally be allowed to take markdowns and co-op advertising, are requesting to do so in writing. They need a paper trail to ensure timely recording and that no fraudulent markdowns are being taken. Thus SOX in a way protects the small manufacturers.

Nevertheless SOX may be overkill. The problem was not any loopholes in GAAP. Deductions such as markdowns, co-op advertising and the like are pretty much common practice in the industry. They need to be appropriately documented and disclosed properly in their 10-K. Internal controls, for instance the kind required of the manufacturer by its external, private investors and lenders, are key. Whether the company is private or public, large or small, internal controls are essential at all levels in a company. It allows the company to keep control of the processes and procedures for recording financial information and if an error is found, it will be easier to correct instead of trying to backtrack. In the end, it saves the company money and embarrassment.

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<sup>1</sup> Verifying a chargeback may also help the customer. In a case involving a plastics manufacturer exporting to the US, a cosmetics company charged back an entire order of containers to the manufacturer claiming all units were scratched. Investigations revealed a new quality control employee of the customer had used a wrong procedure to inspect the units. The manufacturer was absolved and the customer corrected their problem. On the other hand, an unsubstantiated decision by an intermediary to simply withhold payment for an order led to a breakdown in the business relationship, impacting both the manufacturer and the final customer negatively.

Many of the 1195 restatements in 2005, almost double the 613 in 2004, were due to the inability of a parent company to reconcile balance sheet items reflecting inter-company transactions from subsidiaries, requiring parent companies to use plug numbers in consolidated statements. If the SEC determines some numbers look funny, it may trigger an investigation into the company and its subsidiaries, and a restatement in the form of an 8-K must be issued.

## CONCLUSIONS

The Sarbanes-Oxley (SOX) legislation of 2002 was enacted after a series of accounting scandals by some of the largest companies in the US, such as Enron, WorldCom, Global Crossing, Tyco and Arthur Andersen, which resulted in billions of dollars in corporate and investor losses. Compliance is expensive<sup>2</sup>, but lack of investor confidence (e.g. Levitt, 2006) could be turned around and improved control arising out of the need to ensure proper control at all levels may benefit the companies in the long run (Global Credit Service, 2005). The need to investigate, and file restatements in itself is costly. For instance Saks Inc repaid \$42.8 million, including interest on its improper collections, and conducted internal investigations across all divisions, and agreed to cooperate with the investigation being conducted by the SEC and the United States Attorney.

The legislation is still relatively new and companies are still putting their controls in place and getting used to the idea that almost everything they do relating to their financial position needs to be accounted for. There are many ways a company can meet the SOX mandates, like involving operational or line managers with direct, real-time knowledge of their departments' internal affairs, spreading accountability at every level, and using skilled accountants who are objective and impartial, and monitor each and every transaction for accuracy and compliance.

It is interesting that an Act that requires accuracy in financial reporting can have so many potential side effects (see for instance Koehn, J. L., and DelVecchio, S.C., 2006). However, its impact has not always been as predicted and commingling factors such as the dot-com bust or overall economic cycles could have impacted observations in the post-SOX period<sup>3</sup>.

While SOX does not impact small manufacturers who are outside of its purview, there is a trickle down effect in that these firms sell to public corporations that are affected by SOX. For such small manufacturers, one benefit has been that large customers with immense power over their vendors would be more careful about large chargebacks and how they are applied.<sup>4</sup> Such chargebacks are widespread, but are not always reasonable. As the CFO mentioned, regarding unverifiable chargebacks, the problem was typically associated with vague areas in the vendor manuals but was not due to lack of communication. It often stemmed from a customer's need to improve numbers or somehow balance numbers that did not match due to lack of internal controls. The need for a paper trail has restricted such behaviors and even customers, from whom the manufacturer regularly anticipated chargebacks, are now requesting these in writing.

Textile manufacturers face rapid changes in consumer trends for apparel, footwear and accessory items and themselves in turn depend on several vendors. Unexpected and unverified chargebacks can create havoc with the liquidity position of a company and can even force them out of business. However, the expense of complying with

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<sup>2</sup> . In the February 6, 2006, issue of the Retail Weekly Sector published by Global Credit Services, it is estimated that it takes 26,000 additional hours and approximately \$4.3 million to comply with Section 404 of SOX Act. However, the figure can vary with size and not every company is investigated.

<sup>3</sup> For instance, contrary to expectations of a lull in merger activity after its passage, there was actually an increase in the number and the total dollar value of deals (Ibid.). Increased cost of due diligence and even the time required by company management to implement compliance in their own companies were thought to be negative factors, but it appears merged entities could better absorb the cost of compliance. Foreign buyers attracted by the cheaper dollar may be an unrelated factor impacting the number of acquisitions at that time. The costs associated with a complete overhaul of reporting systems have led companies to explore going private to avoid compliance costs, but as Morgenstern et al. (2004) point out, there can be downsides, and private lenders are increasingly demanding similar verifiability.

<sup>4</sup> In general, the largest retailers have so much power over their vendors that only well-established brands with their own distribution channels can even consider not doing business with them, and even then it is news (see for e.g. Fishman, 2006).

SOX will also likely be passed on, either to vendors or to customers in the final count, and could lead to increased cost pressure on vendors.

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