

SUBCONTRACTING AND CREATING MODELS:  
DIFFERENCES IN ACCOUNTING RULES &  
IMPACT ON THE CLASSIFICATION OF UNITS

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For business statistics, the statisticians rely more and more frequently on company accounting data. There are big advantages to do so. Indeed, this information is :

- already gathered within the company for its own use
- collected and provided sometimes through administrative sources
- already harmonized, since it follows the rules of an official business accounting system

Furthermore, company accounting systems have come closer to economic concepts by introducing intermediate calculus as value-added, and by including also a suitable breakdown of turnover for economic analysis. Such accounting rules are in use in most countries, but not always on a compulsory mode and with schedules somewhat varying from one country to another.

Such data are well designed for a good valuation of value-added. Nevertheless, describing the actual activity of a company on that basis may be somewhat fluctuant when specially on the borderline between trade and manufacturing industries.

The purpose of this paper is to point out how the statisticians can classify quite differently enterprises which perform the same kind of activity if they only rely on accounting data. It will also highlight the fact that accounting habits are not always consistent from an economist's point of view.

### **Use of business accounting data for classifying enterprises in manufacturing or in trade industry**

The activity of traders consists in reselling goods without any alteration. The business accounting categories exactly match with the distinction between products which are manufactured by the company and goods for resale. The production is in principle easily measured through precise accounting categories. It is valued by the gross margin which is equal to the commercial margin in the case of a pure trading activity, without any agricultural, manufacturing, repairing or other secondary activities.

In France a company will be classified as a trader if its commercial margin is bigger than any other production<sup>1</sup>. Although companies have been calculating the exact commercial margin since 1984 (New business accounting system), the statisticians have used a simplified rule to decide for any surveyed enterprise whether its main activity is trading or other. They only consider the breakdown of turnover between the two items : 'sales of products' and 'sales of goods for resale'. The last one is weighted by 1/3 to be compared to the other sales of products or services, since gross margin is roughly 1/3 of turnover. Of course, this is a rough approximation since commercial margin goes from 15% to 50% of turnover.

Therefore the classification process is very much relying on the accounting distinction between products and goods for resale. Yet this distinction is not always very clear.

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<sup>1</sup> The theoretical rule relies on value-added which cannot generally be observed by KAU

Reconditioned goods may be considered by the company as product (french business accounting system tends to do so), meanwhile the statistician will on the contrary consider reconditioning as included in the trading activity. But for the statistician, the challenge is to get an homogeneous treatment in the case of selling goods under a dealer name.

### **The dealer brand: a new relationship between the manufacturer and the trader**

The dealer brand (or private brand) is the brand under which a dealer will distribute partly or totally its products. It may be the commercial name of the distributor or another one. For instance, 'St Michael' is the dealer brand of Marks and Spencer who distributes 100% of its goods under this brand. Galeries Lafayette has several dealer brands, for cloths in particular ('Avant première', a dealer brand for women's clothes).

Hypermarkets in France are selling approximately half food and half non-food articles under manufacturer's brands and dealer brands. For the latest (up to 20% of the sales) the commercial name of the dealer ('Carrefour', for example) may be used while specific names ('Tex' for clothes) are used for other type of goods, for marketing purposes. By using this dealer brand, the distributor keeps the exclusive selling rights on the goods.

A brand may be said 'dealer brand' when it is simply affixed on standard goods provided by suppliers with no specific contract with the dealer. We use 'dealer brand' in this paper in a more restrictive sense, i.e. when goods are provided by a manufacturer according to a specific contract including articles and conditions.

In this case, the trader not merely buys the goods to a supplier but gives him specifications and has a commercial responsibility in case of defective goods. In a nutshell, he just acts like a manufacturer towards a subcontractor. The only difference is that the specifications, although precise, have not a high level of technicality and are related to consumer goods.

### **Different kinds of subcontracting**

The development of new relationships between enterprises has enlarged the traditional notion of subcontracting toward a notion of delegate production or industrial partnership. The relation between a subcontractor and his customer is, in some cases, a more equilibrate one and the operations ensured by each party to produce goods are differently dealt with.

The following typology links different kinds of relationship to the operations performed by each party.

### Typology of relationship between enterprises (1)

operation performed	who performs the operation? S = subcontractor or supplier C = customer			
	creation	supplying	manufacturing or assembling	distribution
Provision of work on customer's materials	C	C	S at least for one step	C
manufacturing on the basis of specifications	C	S	S	C
provision of creation and manufacturing	S + C	S	S	C
provision of creation	S + C	C	C	C
manufacturing under license	C owner of the license	S	S	S
manufacturing under the brand name of a trader	S	S	S	C
autonomous production	S	S	S	S
provision of services	S	S	S	S

(1) This typology was used in France in a recent survey conducted by SESSI (Statistical Services of the Department of Manufacturing Industry)

A manufacturer who progressively delegates the manufacturing of its products will in most cases keep himself in mind as a manufacturer. Furthermore, he may sometimes continue thinking so after closing the last factory and, in the meantime, implementing a true commercial network with shops.

On the reverse side, a wholesaler or a retailer may move to a new relationship with his suppliers. Instead of choosing among their standard products, he may give them specifications to manufactured goods that he will resell under his dealer brand name. The suppliers (manufacturers) will have no advertising and distributive costs on these products

and will offer lower purchase prices to this kind of customer. This trader will generally not think of himself as giving order to a subcontractor.

No matter what they are thinking in the two cases, both the manufacturer and the wholesaler (or the retailer) perform the same activity.

Unfortunately, the accounting categories for subcontracting do not clearly apply to this case, in the french business accounting system at least. In this system a distinction is made between:

- (a) - purchase of goods for resale
- (b) - subcontracting included in the direct cost of production
  - subcontracting of reinvoiceable services (like after - sale services)
  - general subcontracting for administrative work
  - purchase of services.

In the case of subcontracting for supplying goods for resale, categories (a) or (b) are both used, depending on the companies. Specifications given to the manufacturer are only model or design for clothing, shoes or furniture and to some extent, choice of the materials. They may consist of a receipt of manufactured foods. The customer, (retailer, wholesaler or manufacturer) may register his purchases either as purchases of goods for resale or as purchases of raw materials, consumables and services.

Meanwhile they may record the sales either as sales of products or as sales of goods for resale, regardless of the way they have recorded the purchases ('purchase of goods for resale' but 'sales of products', for example).

Therefore, the statisticians cannot rely on these accounting registrations, which are not, in most cases, the result of a misregistration but which reflect the extension of new types of relationship between customers and suppliers.

### **Production and creation : new concepts**

Because of the new relationships between manufacturers and traders a new definition of a producer is often used. A producer is the one who organizes the production, he conceives or buys the model, he gets the different factors together (workers, materials, machines) and finances the output. He is responsible for the products. This definition is similar to the one already in use for example for audiovisual activities.

With this extended definition the producer may be a manufacturer, a wholesaler and retailer, providing services like models creation and running royalties. Indeed this kind of producer may perform the activities corresponding to the three steps: creation, manufacturing, distribution. He may also perform none of them and more or less appear as a financial holding in statistics elaborated on the basis of legal units.

The creation of a product is a new coming activity in the NACE rev 1 and in the SNA. The resources provided by this activity are no longer considered as a rent issued from intellectual or artistic property but as true services. In NACE rev 1 a distinction is made according to the kind of products: activity of creation of models for machinery or industrial equipment is included in class 74.20 (architecture and engineering), activity of creation of models for consumer goods is included in class 74.84 (others services to enterprises).

Another type of creation to be considered is the creation of a commercial concept. This creation provides franchise fees. This activity seems to be included in 74.88 as well.

Business accounting categories are not always clear for products, or charges related to these three types of creation. On the products side, recommendations vary and conclude either to register them in 'provision of services' or in 'other products'. As a consequence of the second choice, the turnover will exclude them as well as the production concept of the statistician. The same variations exist on the charges' side where recommendations hesitate between 'purchase of services' and 'other charges', the latest being not included by the statistician in the intermediate consumption.

Thus, as in the case of subcontracting, the use of business accounting data can lead to very different description of the activity and change the border between services (creation of models and of commercial concepts) and trading or manufacturing activities.

If the producer performs at least two of the three functions (creation, manufacturing, distribution), the statistician is generally embarrassed to determine the main activity. Generally speaking, the main activity is the one generating the highest value-added. But other rules are necessarily dealing with integration or 'reverse' phenomena, i.e. retailing the products manufactured by the enterprise itself.

If a manufacturer is only selling his own products through his own retail network, he will remain in any case a manufacturer (value-added criteria will anyway lead to this conclusion). By retailing his own products it is not possible to see him as 'reselling' them; no commercial margin can be measured from the accounting categories and from the accounting data there is no mean to separate the trading activity from manufacturing one. But it is very easy to get separate data on employees and capital (which consist in shops) for this retail activity and, yet, it will not appear among the activities of the legal unit (just like an integrated activity but coming after, instead of being first).

But when a manufacturer sells through his own shops his own products and also goods for resale or products manufactured by a subcontractor, what should be the classification ?

In this case, the consumer goods manufactured by a subcontractor have to be considered as goods purchased for resale under the brand of this customer, the brand being understood as a dealer brand and not a manufacturer brand. Otherwise (that is to say, if the purchases of these goods were considered as subcontracting purchases included in

production costs) it will lead to classify the unit in a manufacturing activity although its value-added is from a trading activity.

## **Proposals**

Within subcontracting, we consider here only the case of consumer goods, i.e. mainly clothes, shoes and fine leather goods, perfumery, jewellery and furniture.

### **Case 1**

Unit A (enterprise) manages a retail network. This network is either an integrated network (chain stores) or a franchised network, of which the unit A is the franchiser. The goods sold are manufactured by a unit B and not by A who only gives specifications. They are sold under the brand name of A. In this case we propose to consider A as a trader (wholesale or retail) and that the brand name is a dealer name. Indeed the value-added of this unit is completely drawn from trading activities.

Some exceptions to this rule correspond to case 2, 3 and 4.

### **Case 2**

If the amount of franchise fees is higher than the commercial margin, the unit A will be considered as belonging to the services sector (NACE 74.88). This case may be met when A is mainly a buying centre, acting as intermediary between the A franchised retailers and the manufacturers (B).

### **Case 3**

If the creation of models corresponds to a high value-added, it will be considered that A is a manufacturing customer and that subcontracting purchases will be part of the production costs of the unit. In this case A belongs to the manufacturing sector and the brand name is a manufacturer brand. That is the case of luxury consumer products attached to a renowned designer (like great fashion designers).

### **Case 4**

Exception to case 3: If A gets nevertheless a high amount of royalties (superior to sales), it should be considered as belonging to a service sector (NACE 74.88).

### **Case 5**

Opposite to case 1: If A is not managing a specific retail network. In this case the unit will be considered as belonging to manufacturing sector as a customer of a subcontractor (B).