

# Treatment of Outsourcing in the International Standard Industrial Classification (ISIC), Rev. 4

by

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## A. Introduction

The term “outsourcing” of production is being used when the principal unit (i.e. principal) contracts another productive unit (i.e. the contractor) to carry out specific aspects of the production activity of the principal, in whole or in part in the production of a good or a service.

While the classification of the economic activity of the contractor has not led to differences in international classification, it has become apparent that the criteria for the classification of the principal outsourcing its economic activity have to be clarified to ensure international consistency in its classification. More specifically, the introductory text of the International Standard Industrial Classification (ISIC) Rev. 3.1 pertaining to the outsourcing of manufacturing activities has to be clarified in the ISIC Rev.4.

This issue has been taken to the Technical Subgroup (TSG) of the Expert Group on International Economic and Social Classifications at its recent meeting in April 2007.

In discussions prior to this meeting, it became evident that there was agreement on how to treat most forms of outsourcing. The treatment of outsourcing of a complete manufacturing process emerged as the main issue that needed to be addressed. The issue put forward to the TSG was therefore formulated as follows:

What criteria should be applied to classify a principal that markets goods under its own name, but has the complete manufacturing process of these goods outsourced to another unit (either within or outside the economic territory). Moreover, considering the criteria what are the main classification categories to be considered: a manufacturer, a wholesaler or yet another treatment?

In considering these criteria, the TSG was asked to determine criteria that are distinct, observable and consistent with the principles of the System of National Accounts and the Balance of Payments Manual.

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In its deliberations on the criteria, the TSG considered the three options: a) ownership of the physical input materials by the principal, b) the ownership of the concept (i.e. intellectual property product) related to the production process or the final good of the principal or c) both the ownership of the physical input material **and** the concept should be applied as criteria to make the distinction in the activity classification of the principal.

## B. Outcome

The TSG recommended that the criterion on where to classify the principal should be based on the ownership of the physical input materials by the principal only.

## C. Implications for the ISIC classification

With this recommendation, the various cases of classification of productive units can be addressed regarding the principal and the contractor: a) outsourcing of support functions, b) outsourcing parts of the production process and c) outsourcing of the complete production process

It should be noted that in each of the following cases, the principal and the contractor may be located within the same economic territory or in different economic territories. The actual location does not affect the classification of either one of these units.

### 1. Outsourcing of support functions

In this case, the principal carries out the core production process (of a good or a service), but outsources certain support functions, such as accounting or computer services, to the contractor. These support functions are not part of the core production process, i.e. do not directly lead to the final good or service, but rather support the general functioning of the principal as a production unit.

In such a case, the principal remains classified to the same ISIC class that represents the core production process. The contractor is classified to the specific support activity it is carrying out, e.g. ISIC class 6920 (Accounting, bookkeeping and auditing activities; tax consultancy) or 6202 (Computer consultancy and computer facilities management).

### 2. Outsourcing of parts of the production process

In this case, the principal outsources a part of the production process (of a good or a service), but not the whole process, to the contractor. The principal owns the (material) inputs to be transformed by the contractor and thereby has ownership over the final outputs.

In such a case, the principal is to be classified as if it were carrying out the complete production process. The contractor is classified according to the portion of the production process that it is undertaking. In case of the transformation of a good, the contractor is classified in the same or separate ISIC category. Also in the case of

outsourcing of a service, the activities of the principal and the contractor might not be classified in the same ISIC category.

### **3. Outsourcing of the complete production process**

Two specific cases have to be considered when the principal outsources the complete production process, namely the case of a) the outsourcing of service producing activities including construction and b) the outsourcing of manufacturing activities.

In the case the principal sub-contracts the complete provision of service-producing activities, including construction, both the principal and the contractor are classified as if they were carrying out the complete service activity.

In the case the principal<sup>2</sup> sub-contracts the complete manufacturing of products to another unit, whereby the principal does not physically transform the goods at the location of the unit, the following activity classifications apply:

- A principal that owns the material inputs and thereby has economic ownership of the outputs, but has the production done by others, is classified to section C (Manufacturing), specifically to the classification category that corresponds to the complete (outsourced) manufacturing activity.
- A principal that has the production done by others, but does not own the material inputs, is classified to section G (Wholesale and retail trade; repair of motor vehicles and motorcycles), specifically to the classification category that corresponds to the activity characterized by the type of sale (e.g. wholesale or retail sale) and type of good sold. In this case, it should also be evaluated if the principal carries out other activities, such as design or research and development. If indeed other production activities are undertaken by the principal, the usual rules for identifying the principal activity of the principal should be applied.
- The contractor in such a case is classified to section C (Manufacturing), specifically to the classification category that corresponds to the manufacturing activity performed by the contractor.

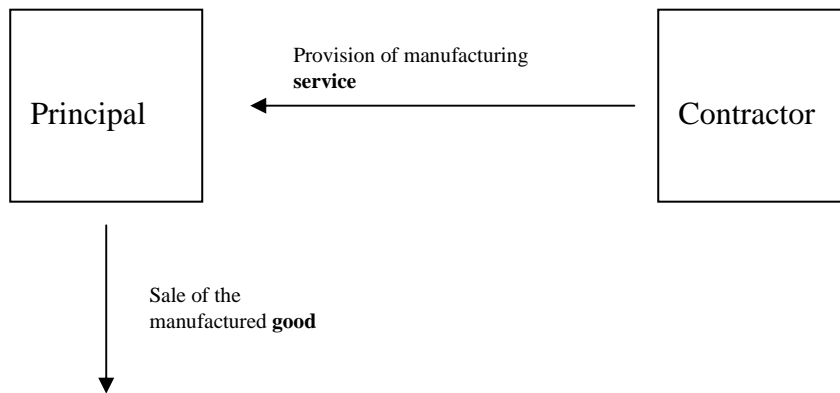
#### **D. Consistency with CPC treatment**

This treatment is also consistent with product classification defined in the CPC. As part of such an outsourcing scenario, the following goods and services would be transacted by the principal and the contractor:

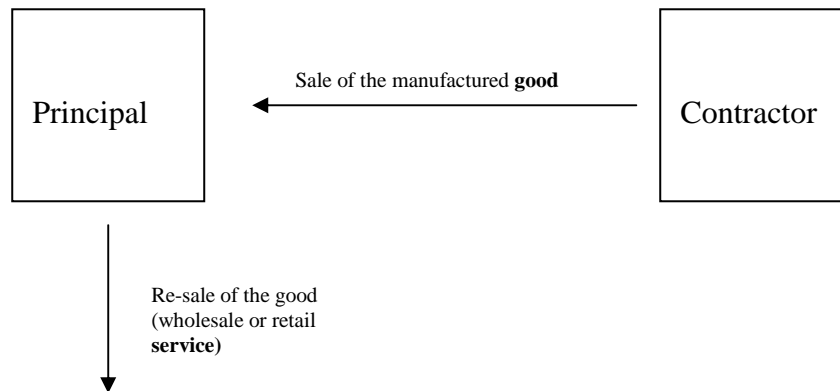
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<sup>2</sup> Also referred to as converters or jobbers

(i) Principal owns the material inputs – contractor provides manufacturing services



(ii) Principal does not own the material inputs – contractor sells manufactured goods



In both cases, the products can be observed and properly measured.

## E. Conclusion

With this international recommendation for the treatment of outsourced activities in ISIC Rev.4 in accordance with SNA and BPM, the international reporting of statistics on production of goods and services should be harmonized. There where countries might decide to report data (for international reporting) according to other criteria (due to delays in backcasting) as outlined in ISIC Rev.4, it is warranted that a description is provided of the implication for the reported statistics. Similarly, the implications in the data collection procedures for the List of Industrial Products (used by UNSD) and Prodcom (used by Eurostat) have to be reported.