Clarification Memorandum No. 3

Classifying SIC Auxiliary Establishments in NAICS

Introduction.--The U.S. Standard Industrial Classification (SIC) designated establishments as being either: (1) operating establishments, or (2) auxiliary establishments (i.e. establishments that primarily serve other establishments of the same enterprise). The SIC Manual provided some specific directions for differentiating ‘auxiliary’ from ‘operating’ establishments. Although those guidelines were revised and expanded over time, they proved to be inadequate. The auxiliary establishment designation, under those guidelines, was generally limited to captive establishments providing services. Captive establishments providing goods were treated as operating establishments. The SIC classification criteria for classifying establishments to industries necessitated distinguishing the type of establishment because the criteria for classification varied by type of establishment. Operating establishments were classified based on what the establishment did; while auxiliary establishments providing services were classified based on the classification of the establishment they served. Therefore, the SIC code was assigned to auxiliaries based on the economic activities of the enterprise and a single digit identifier was assigned to describe the actual activities of the auxiliary unit. The SIC guidelines for auxiliary code assignment are included in Appendix 1.

The North American Industry Classification System (NAICS) which replaced the SIC is based on a production-oriented or supply-based conceptual framework. Establishments are grouped into industries according to similarity in the processes used to produce goods or services. Thus, NAICS does not make a distinction between ‘auxiliary’ and ‘operating’ establishments and classifies all establishments on the basis of what they do without regard to whom they serve. NAICS did however recognize the unique nature of corporate, subsidiary, and regional managing offices. In general, administering, overseeing, and managing are done by all establishments and is not considered a primary activity. However, in multi-establishment enterprises, an establishment may perform managing as its main or only activity. Since the NAICS classification is based on the production process of the establishment, NAICS included an industry for "Corporate, Subsidiary, and Regional Managing Offices", NAICS 551114, for those establishments "primarily engaged in administering, overseeing, and managing other establishments of the company or enterprise." NAICS Sector 55, Management of Companies and Enterprises, is where such establishments are classified.

The following hypothetical enterprise will be used to illustrate the SIC treatment of auxiliaries, the NAICS treatment of these establishments, and various implementation guidelines that should be followed when classifying these activities. The hypothetical enterprise, Mufflers and Tailpipes, Inc., is made up of seven individual establishments performing distinct business functions. Facility A manufactures mufflers. Facility B manufactures tailpipes. Facility C is a warehouse that stores the mufflers and tailpipes made by Mufflers and Tailpipes, Inc. Facility D is a research and design facility that designs the mufflers and tailpipes. Facility E is a separate office created to sell the mufflers and tailpipes to retail auto parts stores. Facility F is Mufflers and Tailpipes Inc.’s corporate headquarters and Facility G is a payroll processing facility for all seven establishments that make up Mufflers and Tailpipes, Inc. Based on these descriptions, the following industry codes would be assigned.
All of the administrative functions associated with Mufflers and Tailpipes, Inc. are classified to motor vehicle part manufacturing in the SIC system because they are providing support functions for the manufacturing activity. NAICS, on the other hand, only classifies the two locations actually manufacturing motor vehicle parts to the manufacturing sector. The other establishments (Facilities C-G) are classified in non-manufacturing sectors based on the actual activities that are performed in each location. It is important to recognize that there may not be any shipments or receipts in some of these facilities. This does not impact their classification.

In this example, all of the activities are clearly delineated in separate establishments and there is no overlap between the establishments. This is an easy classification situation but in many ways unrealistic. Rarely are activities clearly delineated into separate establishments in a multi-establishment enterprise.

The adoption of the single classification principle to all establishments solved numerous problems that existed in the prior classification system. However, in the context of statistical reporting and data collecting, the application of this principle requires direction and guidance. The NAICS United States Manual states that: "An establishment is classified to an industry when its primary activity meets the definition for that industry. Because establishments may perform more than one activity, it is necessary to determine procedures for identifying the primary activity of the establishment.

In most cases, if an establishment is engaged in more than one activity, the industry code is assigned based on the establishment’s principal product or group of products produced or distributed, or services rendered. Ideally, the principal product or service should be determined by its relative share of current production costs and capital investment at the establishment. In practice, however, it is often necessary to use other variables, such as revenue, shipments, or employment as proxies for measuring significance." (NAICS United States 1997, page 17) The most commonly used proxy measure for production in determining primary activity has been receipts or sales. When receipts information is lacking, employment by function has been used to determine significance. However, theses measures are sometimes difficult to collect and even more difficult to interpret. A NAICS industry may include establishments that produce output for sale to others (market transactions) and also may include establishments that produce output (support activities) for other establishments of the same company without a fee. In addition, some establishments may be engaged in both support and market activities.
It became apparent during the 1997 Economic Census processing, as well as in meetings and discussions on NAICS implementation, that if classification consistency among U.S. statistical agencies was to be achieved, the NAICS classification of establishments formerly defined as auxiliaries in the SIC system, and especially central administrative offices/headquarters establishments, required more detailed implementation guidelines. Classification criteria for establishments that are completely support and for those that engage in both support and market activities present unique problems and each of the issues require attention.

1. **Classification of establishments that contain both market and support activities is based on the primary activity of the establishment. The market or support designation does not impact the classification when production functions are evaluated.**

Support activities in a multi-establishment enterprise are primary when they are performed in a separate establishment. In our example, Facility G (payroll) performs a support activity for all seven establishments that make up Mufflers and Tailpipes, Inc. They perform no other support activities. The production function is similar to any market-based payroll processing service. NAICS classifies establishments with similar production functions in the same industry so the establishment is classified in NAICS 541214, Payroll Services.

A single activity can be performed as both a market activity and a support activity. If Facility C (warehouse) from our example stored the goods manufactured by Mufflers and Tailpipes, Inc. and also stored goods for others on a fee basis, the primary activity classification of the facility in NAICS 493110, General Warehousing and Storage, is straightforward. Both the market activity and the support activity are the same.

If our example was modified so that Facility D (R&D) also was providing a small amount of laboratory testing services to outside customers, it would still require far more capital investment etc. to provide the R&D service for Mufflers and Tailpipes, Inc. than to provide the testing service. The only receipts reportable by Facility D would be those from the testing services performed as a market activity. Thus, if receipts were used to determine primary activity classification, the establishment would be classified in NAICS 541380, Testing Laboratories. However, if the primary production function were used to determine the primary activity, the establishment would remain classified in NAICS 541710, Research and Development in the Physical, Engineering, and Life Sciences. In this case, Facility D was created to design mufflers and tailpipes. The R&D activities are the primary activities even though receipts information is only available for the small amount of testing services performed as a market activity. Receipts for such "secondary" activities are becoming more prevalent as support facilities attempt to maximize capacity utilization. For classification of establishments with both market and support activities, determination of primary activity requires evaluation of the production process and, in some cases, of the primary activity of the enterprise.

A final, and more common, example of a combination of market and support activities exists in single establishment enterprises. Single establishment enterprises by their nature contain a primary activity and a variety of the various activities needed to support the primary activity. If the Mufflers and Tailpipes, Inc. example were collapsed into one establishment, the primary activity would be manufacturing mufflers and tailpipes. The support activities would include the
storage, research and development, sales, headquarters, and payroll functions. The single establishment would be classified in NAICS 336399, All Other Motor Vehicle Parts Manufacturing.

**Summary** - Both support and market activities are considered when determining the primary activity of an establishment though the production function is the final determinant. When classifying establishments performing both market and support activities, the rules of combined activities, detailed in Appendix 2, apply. Support activity is considered a primary activity only when it takes place in a separate establishment of a multi-establishment firm where the market activity (if any) is secondary or unrelated to the primary objective of the enterprise.

2. Selling can be a primary activity or a support activity. The nature of selling must be determined prior to assignment of an industry code.

When goods manufactured at an establishment are sold at the same establishment, the selling is a support activity for manufacturing. When legal services are "sold" in a law firm, selling is a support activity. In general, for a single establishment company, selling is inseparable from the production of the good or service. Selling however becomes a primary production function when the establishment is set up to sell the output of the company. Many multi-establishment companies have created specialized establishments dedicated primarily or exclusively to selling products created at other establishments of the company. This is most typical of companies that manufacture goods at one plant and have separate establishments, sales offices, to market these products.

Mufflers and Tailpipes, Inc. has a separate selling establishment, Facility E (sales). In this case, selling is a primary activity for the establishment and it is classified in Wholesale Trade. If Facility E were closed and the sales activities were performed at Facility A (mufflers), selling would be a support activity and Facility A would still be classified in NAICS 336399, All Other Automobile Parts Manufacturing.

Similarly, if Facility E (sales) were closed and the selling activity was performed at Facility F (HQ), the classification of Facility F would not change from 551114. Once again, the selling would no longer be a primary activity.

At the headquarters location of the company, sales may be made and/or recorded. It is imperative that a determination be made as to whether the sales are just being recorded at the headquarters or whether the sales activity is occurring at the headquarters. Sales that are just being recorded would not be considered in determining primary activity. Sales that are made would be considered when determining the primary activity and the ultimate classification of the establishment. However, regardless of the size of the sales activity, if the establishment is identified as a headquarters, it would not be treated the same as an establishment set up to sell the output of a company; rather it would be considered a headquarters (unless it is the headquarters of the wholesale company). The reason for this treatment is that many headquarters of large companies, particularly manufacturing and mining companies, have sales offices located
at the headquarters. If reported sales activity is large, this may suggest classification of the establishment in Wholesale Trade. While this classification would provide for the inclusion of sales data generated from headquarters establishments in the Wholesale Trade data, it would also place large, predominantly managing offices in Wholesale Trade, rather than Industry 551114. This is not consistent with the use of the production process concept for classification. Thus, when selling occurs in an establishment identified as a headquarters, the selling activity is treated as support and not used in the determination of primary activity. The exception to this rule is for the headquarters of a wholesale enterprise. Since the primary activity of the wholesale enterprise is wholesale trade, the headquarters is classified as a wholesale trade establishment if sales are made from that location. This treatment will more likely assure comparability of data, particularly for Sector 55, among the three countries and among U.S. agencies.

Summary - Selling can be a support or a primary activity. It is a primary activity when the establishment is set up for the purpose of selling a company’s products. When selling is purely a support activity (i.e., done at an establishment not set up for the purpose of selling the company's output), it is treated as a combined activity. Using the combined activity rules, an establishment selling its own output is classified based on the ‘primary’ activity it supports. For example, selling combined with manufacturing in a single establishment is classified in manufacturing. Likewise, if selling is combined with headquarters functions in a multi-establishment enterprise, the selling activity is treated as support and the establishment is classified in NAICS 551114.

3. Classification of Corporate, Regional, and Subsidiary Managing Offices - Management activities can be primary or support activities depending on the characteristics of the establishment.

Most industries in NAICS are defined exclusively by their production process. However, NAICS 551114 is unique in that it is defined as including establishments primarily engaged in administering, overseeing and managing other establishments of the company or enterprise. Thus establishments in this industry must be part of a multi-establishment enterprise and they must perform a range of certain kinds of core services (i.e. the services needed to manage an enterprise). These core services include accounting, bookkeeping, billing, legal, marketing/advertising, financial management, personnel management, strategic or organizational planning. Establishments performing two or more of these core activities are classified in NAICS 551114; however, when single support services are done in specialized establishments, the establishment is classified to the NAICS industry corresponding to that activity.

For example, an establishment performing accounting and legal services for other establishment of the company or enterprise would be classified in NAICS 551114, while an establishment performing legal services only for other establishments of the company or enterprise would be classified in NAICS 5411 Legal Services.

In many cases, the headquarters of the company is the location where the key aspects of the
company’s market activity also takes place. This is particularly true in industries such as banking, insurance, publishing, telecommunications, construction, etc. In general, the definitions of the various NAICS industries cover these situations. Thus, the scope of NAICS 551114 is limited to establishments that are not classified elsewhere, and as a result, not all establishments known as "headquarters" would be in NAICS 551114.

The headquarters included in NAICS 551114 may have some market activities. For example, activities may be performed primarily for the convenience of the establishment’s own employees, such as the operation of a cafeteria, fitness center, or day care center and these activities may have receipts. These are not primary activities unless they are separate establishments. If these activities are performed in the headquarters, the establishment is still classified as a headquarters.

In the Mufflers and Tailpipes, Inc. example, Facility F is identified as a headquarters of a multi-establishment enterprise engaged in managing, administering, and overseeing the operations of the enterprise. NAICS includes in Sector 55 establishments "primarily engaged in administering, overseeing, and managing other establishments of the company or enterprise. These establishments normally undertake the strategic or organizational planning and decision making role of the company or enterprise." It is not always clear which support activities constitute ‘management/administrative’ and which do not. In our example, the warehouse, payroll services, sales, and research and development are each separate establishments and are classified based on the activities that they perform. Classification is seldom that easy.

In many instances, the headquarters of a multi-establishment enterprise does much more than undertake the strategic planning and decision making for the enterprise. Often, the accounting, legal, marketing, advertising, human resource, data processing, etc. functions are all performed in the same location. In this case, the establishment is still classified as a headquarters. The staffing patterns, capital requirements, and other elements of the production function more closely resemble other headquarters establishments than any of the single support activities.

When two or more support activities, that cross six-digit NAICS industries, are performed in the same establishment, the establishment is classified in 551114. For example, if Facility G (payroll) was closed and the payroll functions were performed at Facility D (R&D), the combination of support activities that cross six-digit NAICS industries would lead to a classification of Facility D (R&D and payroll) in NAICS 551114.

Finally, it must be stressed that headquarters activities can be primary or support, just as with selling. Headquarters activities are only a primary activity if a separate establishment is created to perform the management role. If the management functions are undertaken in an establishment that also is producing the primary output of the enterprise, the establishment is classified based on the primary activity rather than the management functions. For example, if Mufflers and Tailpipes, Inc. closed Facility F (HQ) and moved all of those operations to Facility A (mufflers), Facility A would still be classified in NAICS 336399, All Other Automobile Parts Manufacturing because manufacturing mufflers is the primary activity. Management activities become support activities in this case.
If all seven establishments in our example were collapsed into one facility, the classification of the facility would be in NAICS 336399. The establishment is manufacturing mufflers and tailpipes as a primary activity and all of the other activities undertaken at that location are support the production of mufflers and tailpipes.

**Summary** - Management can be a primary or support activity. The strategic planning and decision making role of a company is only a primary activity when it is performed in a separate establishment, not undertaking the primary activity of the enterprise. When headquarters functions are combined with a primary output (for example a single establishment manufacturing enterprise), the establishment is classified to the industry of the primary output (in this case manufacturing). All the activities performed must be considered, including processes that define various NAICS industries (other than NAICS 551114) and the relationship of a particular establishment to the balance of a multi-establishment enterprise.
Appendix 1: Auxiliaries in the SIC

"Auxiliaries are establishments primarily engaged in performing management or support services for other establishments of the same enterprise. An enterprise consists of all establishments having more than 50 percent common direct or indirect ownership. Auxiliary establishments are distinguished from operating establishments that primarily produce goods and from those that primarily provide services for personal or household use or for other enterprises. Some examples of activities commonly performed by auxiliaries are management and other general administrative functions, such as accounting, data processing, and legal services; research, development, and testing; and warehousing."

Exceptions and Borderlines

"Some establishments that meet the general definition of auxiliaries are nevertheless treated as operating establishments. They are listed below:

(1) Establishments primarily engaged in producing goods or providing services for other establishments of the same enterprise when such goods or services are covered by industries in Agriculture (Major Groups 01-07 in Division A); Mining (Division B); Construction (Division C); and Manufacturing (Division D) are classified as operating establishments in such Divisions on the basis of their primary activity.

(2) Establishments, including sales branches, sales offices, and sales representatives, primarily engaged in selling tangible products for other than personal or household consumption are classified as operating establishments in Wholesale Trade, with the exception of motion pictures and prerecorded video tapes and disks of the type produced by establishments covered in Major Group 78. Establishments primarily engaged in the wholesale distribution of motion pictures and prerecorded video tapes and disks of the type produced by establishments covered in Major Group 78 are classified in Services, Industry Group 7822.

(3) Establishments primarily engaged in research, development, and testing of aircraft, guided missiles, and space vehicle units and parts, covered by Industry Groups 372 and 376, are classified as operating establishments in these manufacturing industries if they are part of an enterprise that usually manufactures such products. These establishments are often funded by government contracts rather than by funds of the enterprise. Establishments of these enterprises primarily engaged in research, development, and testing of products not covered by Industry Groups 372 and 376 are classified as auxiliary establishments. Establishments primarily engaged in research, development, and testing of products for other enterprises or on a contract basis are classified as operating establishments in Services, Industry Group 873.

(4) Research farms are classified as operating establishments in Agriculture, Forestry, and Fishing, Division A.

(5) Establishments primarily engaged in long-distance trucking, stevedoring, water transportation, or pipeline transportation for other establishments of the same enterprise are
classified as operating establishments in Transportation, Division E.

(6) Establishments primarily engaged in new or replacement construction for establishments of the same enterprise covered by industries in Division E are classified as operating establishments in Construction, Division C. Establishments primarily engaged in repair and maintenance for establishments of the same enterprise covered by industries in Division E are classified as operating establishments in Division E. However, all establishments of the U.S. Postal Service are classified in Industry 4311.

(7) In Public Administration, Division J, establishments primarily engaged in performing central administrative and managerial activities are classified as operating establishments. Establishments primarily engaged in performing other auxiliary activities for establishments in Public Administration, Division J, such as warehouses, automotive maintenance shops, and recreation facilities, are classified as auxiliary establishments.

(8) Establishments primarily engaged in performing auxiliary activities for enterprises that do not have operating establishments in the United States are classified as operating establishments on the basis of the establishment's primary activity in the United States.

Auxiliary Establishments and Industrial Subclassification of Auxiliary Establishments

Auxiliary establishments are assigned four-digit industry codes on the basis of the primary activity of the operating establishments they serve. In addition, they are subclassified further through the assignment of a one-digit auxiliary code, outlined below, based on the primary activity performed by the auxiliary establishment.

Auxiliary Code

1 Central Administrative Offices - Auxiliary establishments primarily engaged in performing management and other general administrative functions centrally for other establishments of the same enterprise.
2 Research, Development, and Testing Laboratories - Auxiliary establishments primarily engaged in performing laboratory or other physical or biological research, development, and testing for other establishments of the same enterprise.
3 Warehouses - Auxiliary establishments primarily engaged in storing raw materials, finished goods, and other products to be used or sold by other establishments of the same enterprise.
4 Auxiliaries, Not Elsewhere Classified - Auxiliary establishments primarily engaged in providing support services, not elsewhere classified, for other establishments of the same enterprise.


The example used in this narrative uses the one-digit code "5" to identify operating establishments.
Appendix 2: Combined Activities in NAICS

Although NAICS does not specifically discuss establishments performing support activities in the section on identifying the primary activity, such activities, when performed in support of the primary activity, can be viewed as produced and consumed activities, or combined activities. The U.S. NAICS manual recognizes two types of combined activities and gives special attention to them. There are two types of combined activities that are given special attention in NAICS. They are vertical integration and joint production. These combined activities have an economic basis and occur in both goods-producing and services-producing sectors. In some cases, there are efficiencies to be gained from combining certain activities in the same establishment. Some of these combinations occur so commonly or frequently that their combination can be treated as a third activity in its own right, and explicitly classified in a specific industry.

One approach to classifying these activities would be to use the primary activity rule, that is whichever activity is largest. However, the fundamental principle of NAICS is that establishments that employ the same production process should be classified in the same industry. If the premise that the combined activities correspond to a distinct third activity is accepted, then using the primary activity rule would place establishments performing the same combination of activities in different industries, thereby violating the production principle of NAICS. A second reason for recognizing combined activities is to improve the stability of establishment classification, both over time and among the various agencies that implement the classification. An establishment should remain classified in the same industry unless its production process changes, and different agencies should code the same establishment or type of establishment in the same way. A consistent treatment of establishments with combined activities is more likely if they are classified to a single industry.

Vertical integration involves consecutive stages of fabrication or production processes in which the output of one step is the input of another. In general, establishments will be classified based on the final process in a vertically integrated production environment, unless specifically identified as classified in another industry. For example, paper may be produced either by establishments that first produce pulp and then consume that pulp to produce paper or by those establishments producing paper from purchased pulp. NAICS specifically specifies that both of these types of paper producing processes should be classified in 32212, Paper Mills, or the final step in paper manufacturing, rather than in NAICS 32211, Pulp Mills. In other cases, NAICS specifies that vertically integrated establishments be classified in the industry representing the first stage of the manufacturing process. Steel mills that make steel and also perform other activities such as producing steel castings are classified in NAICS 33111, Iron and Steel Mills and Ferroalloy Manufacturing, the first stage of the manufacturing process.

The Joint production of goods or services represents the second type of combined activities. For example, automobile dealers both sell and repair autos; automotive parts dealers may both sell parts and repair automobiles; and musical instrument stores may both sell and rent instruments. In the manufacturing sector, establishments may make two different products such as women’s dresses and women’s suits, activities that are classified in two different NAICS industries. In general, receipts/sales and revenue data are used as a proxy to determine primary activity for these establishments. The assumption is that the activity generating the most receipts is also the activity using the most resources and most indicative of the production process.
In some cases, however, these combined activities have been assigned to a specific NAICS industry. [Most] Many of these activities involve either the sale and repair of goods or the sale and rental of goods in the same establishment. For example, establishments that both sell automobile parts and repair automobiles are classified in NAICS 44131, Automobile Parts and Accessories Stores, and those music stores that both sell and rent musical instruments are classified in NAICS 45114, Musical Instrument and Supplies Stores. In other cases, specific industries have been identified for these combined activities such as 44711, Gasoline Stations with Convenience Stores." (NAICS United States 1997, pages 17-18)

In many cases, market activities and support activities are combined at the same location. Consistent with NAICS guidelines, such combined activities are classified to the level of the final stage of production, the primary activity when the primary activity is defined by a production function. An example of this would be a manufacturing plant that also has corporate management, advertising, marketing, payroll, and related support activities all performed at a single location. In this case, the combined activity is classified to the industry of the primary activity, manufacturing. Similar cases exist in services. The headquarters of an insurance company is also where the insurance is actually underwritten. The establishment would be classified as an insurance company rather than a headquarters. Similarly, the headquarters of a professional employer organization (PEO) is undertaking the primary activity of the PEO, and would be classified to the Employee Leasing industry in NAICS.