

CPD-FES Dialogue
Bangladesh Apparels Sector: Does Margin Matter for Ensuring Compliance?

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Margin and Its Relation with Firm level Compliance
Illustration on Bangladesh Apparel Value Chain

Presentation by
Dr Khondaker G Moazzem
Additional Research Director, CPD

CPD Study Team

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Dr Khondaker G Moazzem
Additional Research Director, CPD
and
Kishore K Basak
Senior Research Associate, CPD

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Professor Rehman Sobhan

Chairman, CPD

Professor Mustafizur Rahman

Executive Director, CPD

Dr Debapriya Bhattacharya

Distinguished Fellow, CPD

and

Henrik Maihak

Resident Representative, FES

Topics for Discussion

1. Rationale for the Study
2. Objectives and Methodology
3. Compliance in Sample Apparels Firms
4. Costs for Maintaining Compliance
5. Margin for Suppliers and Buyers/Retailers: Implications for Compliance
6. Issues of Compromise in Maintaining Compliance
7. Towards Building an Integrated Value Chain for Improving Compliance

1. Rationale for the Study

- Weak social upgrading remains a major challenge in the apparel value chain
- Weak 'judicial' governance: serious constraints in maintaining compliance
- Better 'external' governance: a possible avenue to facilitate compliance
- Margin is supposed to be 'neutral' with regard to compliance
 - Necessary costs for compliance are supposed to be built-in the margin
- Compliance is compromised in Bangladesh's apparels sector: benefit the market agents of the value chain
- Low cost for compliance is practiced as a strategic tool for competitiveness and profit
- Focus of the study: whether existing margin distribution limits the scope for maintaining firm level compliance?

1. Rationale for the Study

- Margin received by market agents comprises operational costs and return (profit).
- Three issues dictate the distribution of margin in the competitive value chain
 - Barriers to entry in the market
 - Nature of governance of the market
 - Nature and development of the value chain
- Margin is likely to be reduced in the manufacturing part as opposed to non-manufacturing part of the apparel value chain
- Position of the supplying firm in the tier of the value chain determined distribution of return: Changes in relationship impact distribution of margin
- There is lack of adequate research on nature and extent of relationship between margin and level of compliance

2. Objectives and Methodology

- The study will explore the possible linkages between allocation of margin and maintaining firm level compliance particularly in the context of Bangladesh apparels sector
- The following research questions will be examined in this study
 - a) What is the nature of relationship between allocation of margin and compliance?
 - b) Which factors influence the relationship between the two?
 - c) To what extent the compliance and accountability issues in the apparel sector are relevant for policy makers abroad? and
 - d) What are the possible ways to improve the compliance situation in the Bangladesh apparels sector?

2. Objectives and Methodology

- An exploratory research method has been followed
 - An illustrative case of exploring relationship between margin and compliance
- Key informants of the apparels value chain have been interviewed
 - A total of 15 suppliers and buyers took part in the interview
 - Limited response of suppliers and buyers/retailers: lack of interest to share information about a number of sensitive issues
- The conclusion drawn in this study is rather indicative in nature

3. Compliance in Sample Apparels Firms

- Compliance related standards have changed particularly at the post-Rana Plaza period
- Most of the firms are moderately equipped with major physical compliance related indicators
 - Wide differences between large and small firms; direct vs. sub-contracting firms
- Differences indicate lack of investment as well as lack of proper monitoring and inspection and auditing practices of buyers
- Majority of social compliance related indicators are found to be in better state in the sample firms
- Level of compliance on social issues is better compared to that of physical issues

Physical Compliance in Sample Firms

Items	Level of perception
Toilet facility	U
Fire extinguisher	U
Fire alarm, signs	M-U
Alternative exit for emergency	M-U
Health care/First-aid facility	M-U
Pure drinking water	M-U
Lighting and ventilation	M-U
Electrical safety requirement	M-U
Width & no. of stairs	M-U
Location of warehouse for combustible items	M-U
Dining facility	L-U
Sprinkler	--
Smoke and heat detector	L-U
Alternative exit for emergency	U
Day-care centre	M-U

Note: U=Upper level (score: 8.0-10.0); M=Moderate (5.0-7.99); L=Low (3.0-4.99); VL=Very low (1.0-2.99); Source: Based on interviews (CPD, 2015)

3. Compliance in Sample Apparels Firms

- There is no major difference between different categories of firms in terms of maintaining social compliance.
- Most of the social compliance related indicators are found ranked better in all categories of factories.
 - Minor differences are observed in the case of timely payment of wages, incidents of harassment and abuse and getting weekly leaves.
- Since a large part of these issues have been enforced since early 2000s, no major difference is observed at this stage.

Perception of Owners of Different Categories of Sample Firms on Social Compliance				
Items	Perception Level			
	Small	Large	Sub-contract	Direct
Minimum wage	U	U	U	U
Identity card	U	U	U	U
Participation committee	U	U	U	U
Welfare committee	U	U	U	U
Child labour	U	U	U	U
Service book for workers	U	U	U	U
Forced labour	U	U	U	U
Child labour	U	U	U	U
Discrimination	U	U	U	U
Wage at right time	U	U	U	U
Harassment and abuse	U	U	U	U
Leaves (weekly, sick, occasional and annual)	U	U	U	U

Note: U=Upper level (score: 8.0-10.0); M=Moderate (5.0-7.99); L=Low (3.0-4.99); VL=Very low (1.0-2.99)Source: Based on interviews with apparel suppliers (CPD, 2015)

4. Costs for Maintaining Compliances at Firm Level

- Compliance related fixed and variable costs are supposed to be met from the margin received by suppliers
 - Compliance related costs are usually shown under heads of selling, general and administrative (SGA) cost and overhead (OH) cost of manufacturing
- O'Rourke (2011): Aggregate share of SGA and OH is only 1.8-2.6% of total FOB cost (margin)
 - Only a part of these cost is related to compliance.

Average per Unit Cost for SGA and Manufacturing Overhead for Selected Bangladeshi Products Exported to USA, 2011

Items	Men's Basic 100% Cotton 5 Pocket Denim Jean	Women's Fashion Stretch Jean 98% Cotton/2% Spandex	Men's 100% Cotton Twill Casual Pant	Women's Textured 96%Polyester/4%Spandex Zip Trouser	Men's Polyester Active T-Shirt	Women's 100% Cotton Polo Shirt (Dark Jersey 6.5 Oz.)
SGA \$	0.02	0.03	0.03	0.02	0.01	0.01
Mfg. OH \$	0.16	0.2	0.18	0.16	0.07	0.07
FOB Cost \$	7.57	8.91	7.99	5.68	4.34	4.68
Percent of FOB Cost (Margin)						
SGA \$	0.3	0.3	0.4	0.4	0.2	0.2
Mfg. OH \$	2.2	2.3	2.3	2.9	1.7	1.6

Source: Authors' calculation based on O'Rourke, 2011

5. Margin for Suppliers and Buyers/Retailers

5.1 Margin for Suppliers

- Suppliers usually receive cutting and making (CM) charges
- Raw materials comprised of a major part of the total CM cost
 - Followed by industrial costs and other costs (transport, banking, alternate source of energy, depreciation cost)
 - Compliance related cost is a minor part of 'other cost'
 - About 3-10% of total CM is the net profit margin for the suppliers
- Expenses related to 'other costs' are higher for large firms and for those working under direct contract
- Overall spending on compliance and level of compliance at the firm level is likely to be closely associated

Manufacturing Cost of Various Apparel Products

Products	Percentage of total manufacturing cost			
	Raw materials	Industrial costs	Others costs	Net margin
T-shirt	60-70%	15-20%	10-20%	3-10%
Polo shirt	60-65%	15-18%	15-20%	3-6%
Bottom	60-65%	15-18%	15-20%	3-5%
Pyjama set	75%	12%	10%	3-4%
Shirt	60-70%	15-20%	10%	2-10%

Source: Based on interviews with apparel suppliers (CPD, 2015)

5. Margin for Suppliers and Buyers/Retailers

5.2 Margin for Suppliers in Other Countries

- Differences of costs are rather high between Bangladesh and other supplying countries for number of items
 - SGA:50-400%; Labour costs: 5-300% and Mfg OH: 30-75%
- Significant differences observed in fabric and trimming related costs between Bangladesh, China and Vietnam

Differences in Costs between Bangladesh and Other Countries (Men's Basic 100% Cotton 5 Pocket Denim Jean)

	China	Vietnam	Mexico	Honduras	Haiti	Nicaragua (Mexico)	Nicaragua (China)
FOB Cost US\$	7.69	7.62	8.63	8.89	8.67	8.4	8.29
Difference in costs between Bangladesh and other countries (%)							
FOB Cost \$	1.6	0.7	14.0	17.4	14.5	11.0	9.5
Fabric Cost \$ /Garment	-5.1	-1.1	2.7	5.8	10.2	6.0	4.0
Trim/Packaging Cost \$/Garment	-2.6	-0.9	6.1	7.9	8.8	8.8	8.8
Labor \$ / Garment	160.1	35.1	287.0	309.1	114.9	150.0	150.0
Mfg. OH \$	37.5	31.3	75.0	62.5	56.3	31.3	31.3
SGA \$	150.0	50.0	400.0	400.0	150.0	200.0	200.0
External Wash/Embroidery \$	0.0	0.0	15.0	12.5	17.5	10.0	10.0
Additional Seconds \$	-23.1	-11.5	-15.4	3.8	15.4	-15.4	-19.2
Mfg. Profit 10%	1.5	0.0	14.9	17.9	14.9	11.9	10.4
Freight, Insurance	-4.3	-4.3	-30.4	-21.7	-17.4	-17.4	-17.4

Source: Authors' calculation based on O'Rourke, 2011

5. Margin for Suppliers and Buyers/Retailers

5.3 Implications for Compliance

- Bangladesh spent lowest amount for various kinds of costs which are not directly related to production including those of compliance (O'Rourke, 2011)

Comparison of Non-manufacturing Costs between Different Countries (including compliances) (in US\$ per piece)								
Items	Non-manufacturing costs (US\$ per piece)							
	China	Vietnam	Bangladesh	Mexico	Honduras	Haiti	Nicaragua (Mexico)	Nicaragua (China)
Men's Basic 100% Cotton 5 Pocket Denim Jean	0.37	0.34	0.28	0.5	0.48	0.42	0.39	0.39
Women's Fashion Stretch Jean 98% Cotton/2% Spandex	0.32	0.28	0.23	0.48	0.47	0.37	0.32	0.32
Men's 100% Cotton Twill Pant	0.31	0.25	0.21	0.47	0.46	0.35	0.31	0.31
Women's Textured 96% Polyester/4 % Spandex Zip Trouser	0.3	0.22	0.18	0.44	0.42	0.35	0.3	0.3
Men's Polyester Active T-Shirt	0.13	0.1	0.08	0.25	0.23	0.14	0.14	0.14
Women's 100% Cotton Polo Shirt (Dark Jersey 6.5 Oz.)	0.13	0.1	0.08	0.25	0.23	0.14	0.14	0.14

Source: Authors' calculation based on O'Rourke, 2011

5. Margin for Suppliers and Buyers/Retailers

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5.3 Implications for Compliance

- The lowest costs for SGA and manufacturing OH in Bangladesh is perhaps related to the lowest margin (as FOB costs) for its products
- Bangladeshi firms have struggled to investment more for compliance
 - Rise of compliance related expenses may reduce competitiveness
 - Accommodating additional costs by cutting suppliers' profit not be so easy in low-level of profit margin
 - Improving the level of cost efficiency such as costs for fabric and trimming and packaging requires investment and time
- Bangladesh's average fabric costs was US\$0.18 higher than that of China and US\$0.05 higher than that of Vietnam.
 - A reduction of costs for fabric at par with other competing countries would provide more resources to Bangladeshi firms which could be used for improving compliance.
- Under a competitive backward linkage market, it is not so easy to reduce those cost without undertaking medium to long term investment for improvement of efficiency and productivity

5. Margin for Suppliers and Buyers/Retailers

5.3 Implications for Compliance

- Firms in other countries spent more on compliance
- Firms of competing countries enable to maintain their competitiveness through other means.
 - There are many economic and non-economic factors that play important role for better competitiveness
- Without sufficient improvement in those factors, it would be very difficult for Bangladeshi manufacturers to increase spending for compliance under the existing level of margin

Advantages Enjoyed by Suppliers of Other Competing Countries: Perception of Bangladeshi Suppliers

Low interest rates	Lower operating cost
Developed infrastructure	Higher productivity
Skilled labour force	Low wastage
Semi-automated production process	Duty free access
Financial incentives	Short lead time
Higher labour efficiency	Short freight time
Low cost of raw materials	

Source: Based on interviews with apparel suppliers (CPD, 2015)

5. Margin for Suppliers and Buyers/Retailers

5.4 Margin for Buyers

- The bulk of buyers' gross margins reflect a charge to cover distributors' cost of doing business (40% of the final sale price)
 - Remainder reflecting net profit margins at the wholesale and retail levels
- R. Sobhan (2014) & M. Rahman (2014): Margin distributed at suppliers' end was about 28% while the rest 72% is distributed at the buyers' end.
- The large share of total margin is distributed at the buyers' end
 - Need to be discussed from market based analytical perspective

Distribution of Margin in the Apparel Value Chain (At Suppliers' & Buyers' End)

Items	Fair Wear Foundation Currency: €, 2013	Clean Clothes Foundation Currency: USD, 2014
	% of Retail Price	
Labour	0.6%	0.7%
Materials	12%	12%
Overhead	0.9%	1%
Factory Gross Margin	4%	4%
FOB Cost	17%	18%
Customs, Transport, Warehouse, etc.	8%	8%
Agent Fee	4%	-
SGA	-	4%
Clothing Brand Gross Margin	12%	12%
Wholesale Cost	41%	42%
SGA	-	34%
Retail Profit	-	24%
Retail Cost	59% (incl. profit)	-
Retail Price	100%	100%

Source: Based on different studies

5. Margin for Suppliers and Buyers/Retailers

5.4 Margin for Buyers

- The profit received by the retailers/buyers include investment of capital, market intelligence, market risks, productivity and other factors.
 - The wholesaler bears all the costs of post-FOB including customs, transport, warehousing and agent fees.
 - The clothing brand gross margin includes a cost and a profit element: some additional costs at the brand level include staff and rent whereas the profit element is the brand profit the wholesaler enjoys.
 - Retail profit is approximately 24% which is the highest profit margin commanded by any player in the value chain (Sarasin, 2014)
- Reasons that pose systemic risk to retailers: justify their higher margins
 - Inventory control; supply chain optimization; automation of businesses and integration of business functions
- Market operations at the buyers/retailers' end is quite different with that of suppliers' end
- A disjointed value chain is in operation in the apparel value chain of Bangladesh
 - Existing structure and market forces put little emphasis on compliance

6. Compromise with Maintaining Compliance

6.1 Costs for Establishing Factories

- Factories set up taking into account a short maturity period (between 5 yrs)
 - Depreciation cost currently appears to be high.
 - A low depreciation cost could provide firms additional resources for spending on compliance.
- Suppliers' priority in renting space and/or constructing buildings is usually guided by cost.
- Firms may try to spend less on development of necessary facilities required for OHS at the work place
- Firms usually intend to compromise in maintaining compliance related to OHS

Period for Viability of a Project Considered by Sample Firm Owners

	Between 5 years	Between 6-10 years	Over 10 years
Small	75%	25%	0
Large	75%	0	25%
Sub-contracting	67%	33%	0
Direct	100%	0	0

Source: Based on interviews with apparel suppliers (CPD, 2015)

Priority Issues Considered by Sample Firm Owners in case of Different Fixed Assets (% of respondents)

Priority of considerations for constructing/renting a building (%)		Priority of considerations for placing electrical wiring system (%)	
Effective area/space	43	Costs of equipment	50
Costs of land/rent	35	Brand	37
National rules for setting up factory/Buyers' guideline	16	Buyers' guideline/ National rules	13
Workers' facilities as per law	6	Others	0

Source: Based on interviews with apparel suppliers (CPD, 2015)

6. Compromise with Maintaining Compliance

6.2 Changes in Retail Price and Its Implications on Margin and Compliance

- It is apprehended that changes in retail price and its impact in the distribution of margin at the chain are likely to have implications on investment for compliance
- Reduction of price may or may not reduce margin and profit of any or all players in the chain provided productivity and efficiency in the value chain increased at a faster rate than the reduction of price.
 - Moazzem and Sehrin (2015) firm level productivity has increased about 10-12% per year during 2005 to 2013
 - Retailers are also adopting various cost minimization initiatives to increase their profit margins.
 - Andrew Billings and Amy Burns (2012): many apparel companies view vendor negotiation as a primary lever for cost reduction.

6. Compromise with Maintaining Compliance

6.3 Suppliers' Strategies at Different Business Situation

- In a business which is in usual situation, suppliers prioritise different issues in a balanced manner
 - Maximising profit, size of orders, maintaining business links with buyers and ensuring profit per unit of output
- During the difficult situation, firms put more emphasis on ensuring total amount of profit
 - Firms of all categories try to reduce cost of production by targeting worker related costs such as reducing overtime work

	Small	Large	Direct	Sub-contracting
Monthly wage costs	-	25	20	-
Overtime benefit	60	75	80	50
Costs for other social benefit	-	-	-	-
Costs for social compliances	-	-	-	-
Other	40	-	-	50

Source: Based on interviews with apparel suppliers (CPD, 2015)

6. Compromise with Maintaining Compliance

6.4 Issues related to the Guidelines followed by Buyers/Retailers/MNEs

- Several standards including the OECD Guidelines for MNEs and the ILO Tripartite Declaration although focus on direct contractors, lack proper guidelines for establishing responsibility of buyers towards subcontractors
- UN Global Compact (UNGC) makes an attempt to outline and clarify corporate responsibilities by advancing the concept of the “sphere of influence”
 - The “sphere of influence” ended up more like “mapping” impacts than “limiting” responsibilities”
- UN “Guiding Principles on Business and Human Rights: Implementing the United Nations ‘Protect, Respect and Remedy’ Framework: Provide guiding principles of responsible businesses
- The SA8000 is perhaps one of the most established certification schemes to develop and maintain socially acceptable practices in the workplace
- Buyers and retailers are diverge in nature and are not necessarily MNEs.
 - A large part of these buyers are not guided by the principle for MNEs and UNGC.
 - It remains unclear how small buyers comply to domestic regulations of buying countries

6. Compromise with Maintaining Compliance

6.5 Operational Practices of Audit Firms

- Traditional social audit process contains three main parts: a physical inspection of the factory, documentation inspection and, interviews with workers (Bjorkman & Wong, 2013).
- An audit typically takes between 1 to 2 days which is a major criticism as they tend to be “too short, superficial and sloppy to actually identify certain types of code violations”
 - Interviews are held with the managers and senior staff whose work is related to the labour standards
 - Much of the focus is on senior staff members who may manipulate the information to social auditors leading to a distorted report
- Social audits are further criticized for their announcement of factory visits before arriving allowing managers to give a false impression of working conditions (CCC, 2005)
- Suppliers maintain a model factory while sub-contracting the bulk of their work to another factory where working conditions are significantly poorer which helps the factory get a good audit report and secure more international orders (CCC, 2005)

6. Compromise with Maintaining Compliance

6.6 Relationship between Auditors and Other Agents

- External auditors are generally more reliable than their internal counterpart
 - External auditors sometimes compromise ethical reporting to satisfy their client by giving them a good rating (Bjorkman & Wong, 2013)
 - This undermines the fundamental purpose of a social audit
- Bjorkman & Wong (2013): Supplier-auditor relationship is also not as professional as it should be
 - One of the reasons auditors do not like to arrive unannounced is that they do not want to jeopardize their relationship with the suppliers

7. Towards Building an Integrated Value Chain for Improving Compliance

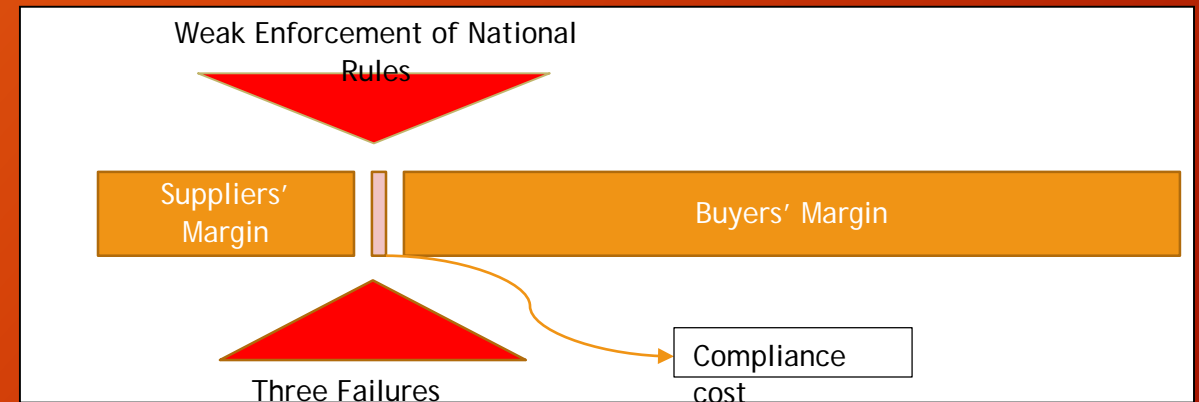
- Ensuring firm level compliance is a complex issue: the primary responsibility for maintaining compliance at the firm level goes to regulators at supplying country
- In the backdrop of weak governance, alternate mechanisms need to function well.
- Three kinds of failures are identified
 1. **Addressing Market Failure**
 - Two segmented markets operating in the value chain
 - Compliance related costs are opaque and non-transparent in the cost structure both at the suppliers' and the buyers' end
 - An integrated value chain in the apparels sector is needed
 - Market players will jointly share responsibility in the whole value chain.
 2. **Addressing Coordination Failure**
 - Social audit initiative of the buyers need to be well coordinated with that of national monitoring system
 - The buyers/brands/retailers while providing orders to suppliers are supposed to take into account that necessary compliance are maintained.

7. Towards Building an Integrated Value Chain for Improving Compliance

3. Addressing Information Failure

- A number of international guidelines on responsible business practice of the MNEs/buyers are available which particularly focus on workers' rights and workplace safety and security
 - Implementation of those guidelines is rather weak

Fragmented Value Chain with Limited Focus on Compliance Costs through Different Means

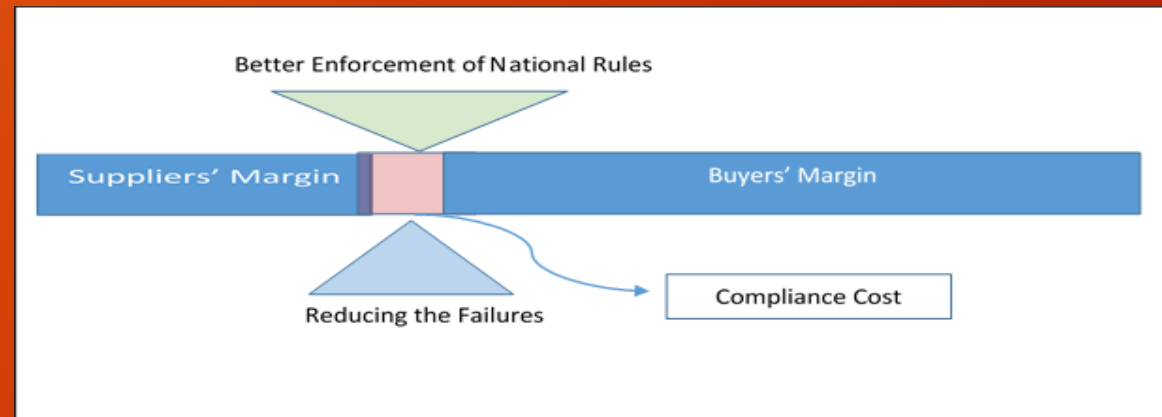


Source: Prepared by authors

7. Towards Building an Integrated Value Chain for Improving Compliance

- Seven measures and initiatives need to be taken into account in order to develop an integrated value chain in the apparels sector.
 1. The allocation for maintaining compliance by apparel firms need to be increased; a part of this additional spending could come from higher CM.
 2. The component of compliance related expenses need to be made separate in the cost structure of the suppliers as well as of the buyers/retailers.
- There should be appropriate mechanism under which spending on compliance could be monitored transparently.

Integrated Value Chain addressing the Compliance Costs through Different Means



10. Towards Building an Integrated Value Chain for Improving Compliance

3. Suppliers should take necessary measures to generate additional resources in order to spend on compliance by further reducing production cost by improving productivity and efficiency.
 - The attitude towards lowering the spending for compliance in order to increase the return needs to be avoided.
4. The institutional mechanism to monitor and inspect the factory level compliance needs to be ensured.
 - The government should allocate more resources for enhancing the capacity of respective organizations as well as take initiatives to strengthen their governance practices.
5. The social audit system practiced by the buyers/retailers need to be strengthened
 - Different players including occupational health and safety committee, national and international NGOs, working on social issues need to be integrated in the auditing process.

10. Towards Building an Integrated Value Chain for Improving Compliance

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6. Strengthening international rules, norms and guidelines are also necessary
 - With a view to better regulate the buyers/brands and retailers to ensure compliance
7. All kinds of market agents from buying countries who are engaged in sourcing of apparels need to be registered under proper authority
 - Have to follow international guidelines and to be monitored properly

11. Concluding Remarks

- Present study has been carried out at a time when Bangladesh's apparels sector is undergoing major restructuring on physical and social compliances
 - Such restructuring initiatives are quite unique in the context of global apparels value chain
- Firms have to make considerable amount of investment in order to address the weaknesses in fire, electrical and physical integrity which have been identified through various inspections.
- Suppliers expect that such investment on compliance will not only ensure better workplace safety and security at the same time would ensure better return for them.
- Present study has strong relevance in this present context of improvement of firm level compliance and how it is related to the suppliers' margin.
- Along with strengthening the institutional mechanism, both suppliers and buyers have to take responsibility towards ensuring compliance in the production process

Thank you
<moazzemcpd@gmail.com>