# Manufacturing – distribution - leasing

# Issues Paper 2

## Objective

1 The objective of this session is to:

(a) complete the discussion on Distribution started in the meeting on 7 March 2024 and reach a decision on how to structure the classification;

(b) discuss the topic on leasing.

**2 This paper integrates the Paper 07-01 prepared for the 7 March 2024 that has been again uploaded for this meeting as paper 07-02.**

3 This paper contains two chapters:

(a) Manufacturing and distribution;

(b) Leasing

## Introduction

4 The overall purpose of SEC 1 is to provide guidance to undertakings to identify the sector-specific standards that are relevant for them by classifying groups of economic activities into ESRS sectors and sector groups.

5 SEC 1 does this by aggregating NACE Classes (and the economic activities described thereunder) into groups which become then an ESRS Sector. This aggregation has two important consequences:

(a) The aggregation of NACE Classes aims at identifying the sustainability matters and the disclosure requirements that are common to the undertakings required to apply a given standard.

(b) Adding a NACE Class economic activity to a group expands the boundary of the ESRS sector that is being created (i.e. the same sector ESRS will be applied to an additional category of entities). It is therefore a balancing act between separating "pure" players in a particular economic activity (e.g. distributors of very different goods) from "horizontally integrated undertakings". The latter undertakings will find that particular economic activities naturally are part of their overall activities, while the "pure" player delivers its products to many industries. An example: "*NACE Class C.24.20 Manufacture of tubes, pipes, hollow profiles and related fittings, of steel*"; while this NACE Class is part of the Metal processing sector, it is an activity that is also exercised by undertakings in the Construction Materials sector, so the NACE Class could be added to the latter sector as non-boundary defining. In contrast the "pure" NACE C.24.20 player would remain within the boundary of the Metal processing sector.[1]

6 Undertakings may have to apply more than one ESRS Sector standard. In particular undertakings shall report according to the sector-specific ESRS that are its significant sectors. According to ESRS 2 paragraph 40 (b) and (c) and Application Requirements 12 and 13 of the Delegated Act supplementing Directive 2013/34, a sector is significant if it:

(a) generates revenues above 10 per cent of the revenues of all its activities ; or

(b) is connected with material actual impacts or material potential negative impacts.

7 Undertakings, irrespective of the sector they belong to, will have to report on material IRO's that arise in their value chain. ESRS 2 does not clarify if "connected" here is limited to the impacts that originate from own operations or it includes also the value chain. If it would include also value chain, it means that a distributor of textile products and food would have to apply three standards: Retail and Sales, Textile and Food and Beverage. For practical reasons, it would be preferable that a given standard also covers disclosures that capture the typical IROs related to the sectors that are upstream and downstream from that sector itself. For example, a specialised distributor of textile products should be able by applying a single standard to cover the IROs of the typical distribution processes (linked to storage, logistics, transportation) and the IROs of their typical supply chain (linked to textile). However, this will not be always feasible.

[1] Please refer to the EFRAG Secretariat proposals in the SR TEG meeting of 19 March 2024.

## Previous discussion

8 The EFRAG Secretariat presented in the workshops with the sector communities in February 2024 SEC 1 draft, where the specialised distribution activities were allocated conventionally to the respective manufacturing sector. The message in many of those workshops was that it would on the contrary be <u>preferable to have the specialised distribution activities combined with the Retail and Sales sector</u>, to allow to achieve the desired level of commonality in IROs.

9 The EFRAG Secretariat proposed in the meeting on 7 March a modified approach, where the specialised distributors are treated in a separate segment of the manufacturing standard. Such segment would cover the IRO linked to the distribution activities, while in the same standard also the upstream disclosures would be covered. This would facilitate the reporting of integrated undertakings.

10 <u>The SR TEG discussion on 7 March showed mixed views.</u>

11 Several members supported the proposal of EFRAG Secretariat, suggesting that Retail&Sales is treated as a residual sector (including wholesale distribution), while specialised distributors are included in the Manufacturing sector pertaining to the goods and services that they distribute. If specialised distributors are separated from manufacturers and aggregated to the Retail&Sales, a distributor that sells 15 different types of products would have to look at 15 different sector standards and this would not be practical. They did not see how a single Retail&Sales sector could capture all the different aspects linked to the different goods and services sold.

12 Other members, including two preparers, on the contrary, considered that separating the specialised distributors from the manufacturers would make more sense. Aggregating them with the rest of Retail&Sales would allow to fully reflect the commonalities of own operations (wharehousing/logistics, transport). They considered that own operations of specialised distributors are closer to the ones of retailers than to those of manufacturers. If there is no vertical integration, the distributor would not have the ability to report on its supply chain with the same level of detail and quality as it does for own operations; as such the disclosures should not be the same that are required to be reported by an integrated entity. Aggregating the specialised distributor with the manufacturer would not bring the right behavioural incentive: the focus of sustainability reporting should be on the areas on which the undertaking has power to promote a transition and this is own operations, which for the distributors are similar in terms of IROs to entities in Retail&Sales.

13 It was noted the importance of the definition of specialised distributor. For example, a distributor of textile products should not be able to escape the reporting of textile related disclosures only because it also sells other goods.

### Illustration of two alternatives

14 To illustrate the way forward on dealing with wholesale and retail sale activities under SEC 1, the EFRAG Secretariat discusses below the following different business models[2]:

(a) Integrated manufacturer: an undertaking that is vertically integrated from raw material supply to product distribution;

(b) Specialised distributor: an undertaking that is specialised in selling products that are solely classified under a single sector; and

(c) Wholesale operator: an undertaking that sells products that belong to different sectors.

15 The table below illustrates the consequences in terms of reporting for integrated entities and specialised distributors in the two alternatives: Specialised distributors included in Manufacturing and Specialised distributors included in Retail&Sales.

| **Entity/Alternative** | **Specialised distributors included in Manufacturing** | **Specialised distributors included in Retail&Sales** |
|---|---|---|
| **Integrated entity** | The undertaking applies a single standard.<br><br>A specific subsegment of the standard covers the IROs related to distribution. This segment has more similarities with Retail&Sale standard than with the manufacturing segment. The standard will be longer as it will include also the Retail&Sale type of disclosures. | The entity applies two standards: the one dedicated to Manufacturing and the one dedicated to Retail&Sales. |

[2] Business model is defined under ESRS as "The undertaking's system of transforming inputs through its activities into outputs and outcomes that aims to fulfil the undertaking's strategic purposes and create value over the short-, medium- and long-term. ESRS use the term "business model" in the singular, although it is recognised that undertakings may have more than one business model."

| | | |
|---|---|---|
| **Specialised distributor** | The undertaking reports using the disclosures in the relevant subsegment, which are similar to the ones in the Retail&Sales ESRS.<br><br>Supply chain related disclosures can be found in the same standard (in the manufacturing segments). The standard will have to reflect when appropriate that in this case the disclosures are value chain related and not own operations related (e.g. in terms of leverage and data collection). | The undertaking reports on own operations using the Retail&Sales ESRS.<br><br>As Retail&Sales sector cannot cover the IROs related to the multitude of possible products, for supply chain disclosures the entity has also to <u>refer to the different manufacturing ESRS</u> related to the goods and services that it sells. |

16 Retailers that distribute more than one single product type will have in both alternatives to report using the Retail&Sales standard. For them in both alternatives in terms of standard setting there is the issue of how to cover the IROs arising from the supply chain, as they are covered by other sectors and not by the Retail&Sales sector. Likely in this case <u>the undertakings will have to refer to the respective manufacturing standards</u> related to the goods and services that they distribute, when material value chain IROs are identified.

**Conclusions:**

17 Both approaches have advantages and disadvantages.

18 Aggregating the specialised retailers with the manufacturing sector (as a separate segment) will result in a longer standard that has many similarities with Retail&Sales; this allows specialised retailers and integrated entities to find in a single standard both the disclosures related to own operations and those related to the supply chain.

19 Aggregating the specialised retailers with the Retail&Sales will result in both the integrated entities and the specialised retailers to have to apply multiple standards, one for own operations (Retail&Sales) and one or more for supply chain disclosures (depending on the goods and services they distribute.

20 The EFRAG Secretariat confirms the preference for having the specialised retailers in a separate segment within the manufacturing sector. This will be anyway subject to the consultation when SEC 1 ED is issued.

**Questions for EFRAG SR TEG**

21 Does EFRAG SR TEG agree with the proposal of the EFRAG Secretariat?

## Leasing

22 All 36 NACE Classes (please refer to Appendix 2) that relate to leasing refer solely to the lessor perspective. Reporting from the lessee side does not affect the SEC 1 Sector Classification for two reasons: i) all leasing in the NACE Classification refers to the lessor perspective, and ii) all undertakings in the economy can act as lessees of different underlying items.

23 In order to identify who should report on the IROs associated to the leased asset, the EFRAG Secretariat proposes to look at who is entitled during the reporting period to the right-to-use of the underlying asset (e.g., a car, a ship, or a tractor). The proposal suggests no difference in treatment between operational leasing and financial leasing, as they expose undertakings to substantially the same impacts. In practice, it is usually the lessee who manages and operates the underlying asset, thereby having right-to-use it during the lease period.

24 The EFRAG Secretariat observes that, fundamentally, for impacts there is no difference in the sustainability matters (SMs) and disclosure requirements (DRs) between “bought” and “leased” underlying assets. For example, a leased car pollutes as much as a purchased one, and this principle applies to other impact related SMs related to the underlying assets.

25 The EFRAG Secretariat considered whether for financial materiality (disclosure on material risks and opportunities) the same approach used for impacts would be appropriate or whether there should be an approach closer to the financial reporting approach. Based on IFRS accounting standards, a financial lease is treated similarly to a lending transaction, where the lessee recognises in its accounts the risks and rewards associated to the ownership of the asset (i.e. the asset is recognised on balance sheet, as well as a financial liability associated to it). On the contrary, operating leases are treated as service contracts, where the lessee only recognises the fees corresponding to the rentals of the reporting period.

26 The EFRAG Secretariat considers that the same approach as for impacts should also be adopted for the risks and opportunities. This is because what matters in sustainability reporting is not the financial risks and rewards arising from the ownership of the asset, differently from what is done in financial reporting. Here the focus is on risks and

opportunities arising from impacts, dependencies or other factors (e.g. systemic regulation) pertaining with the specific sustainability matter.

27 For example, an undertaking (lessee) that aims to reduce its GHG emissions, may ask the lessor to provide electrical cars for its fleet. While this would help in reducing the greenhouse gas impact of the undertaking, it will result in a higher financial impact as electrical cars are generally more expensive than cars with a combustion engine. As such, the proposed approach would allow to capture the financial risks associated to climate change arising **from the use of the leased asset**.

28 However, as part of the value chain reporting, the lessor would have to report the material impacts deriving from its downstream relationships. The EFRAG Secretariat considers that, for example, if a lessor leases a car fleet to a logistic company, including in the sustainability statement of the lessor the Scope 3 GHG emissions of those cars (that are used by the logistic company) would provide relevant information. From a practical point of view, the lessor could prepare an estimate of Scope 3 GHG emissions on the basis of the number of kilometres for the period and this in an information to which in general they have access.

29 On this specific point, conceptually the inclusion of the impacts that derive from the use of the leased assets in the sustainability statements of the lessor produces relevant information. However, beyond GHG emissions, it will be necessary to make specific considerations including on practicability, before introducing the requirement to include these impacts in the metrics.

30 The EFRAG Secretariat proposes to assign the leasing activities in the NACE Classification as follows to the underlying ESRS Sectors. Generally, financial leasing is assigned to the Credit Institutions sector, while operational leasing activities are assigned to the manufacturing sectors they relate to, as part of the Distribution subsector of each ESRS sector as discussed in chapter 1 of this paper.

| ESRS Sector | NACE Class | |
|---|---|---|
| Agriculture, Farming and Fishing | A.01.61 | Support activities for crop production |
| Forestry | A.02.40 | Support services to forestry |
| Power production and utilities | D.35.14 | Distribution of electricity |
| Power production and utilities | D.35.22 | Distribution of gaseous fuels through mains |
| Water and Waste | E.36.00 | Water collection, treatment and supply |
| Construction and Engineering | F.43.99 | Other specialised construction activities n.e.c. |
| Sales and Trade | G.47.91 | Intermediation service activities for non-specialised retail sale |
| Road Transport | H.49.33 | On-demand passenger transport service activities by vehicle with driver |
| Road Transport | H.49.41 | Freight transport by road |

| | | |
|---|---|---|
| Road Transport | H.49.42 | Removal services |
| Other transportation | H.50.10 | Sea and coastal passenger water transport |
| Other transportation | H.50.20 | Sea and coastal freight water transport |
| Other transportation | H.50.30 | Inland passenger water transport |
| Other transportation | H.50.40 | Inland freight water transport |
| Other transportation | H.52.24 | Cargo handling |
| Other transportation | H.51.10 | Passenger air transport |
| Other transportation | H.51.21 | Freight air transport |
| Information Technology | K.63.10 | Computing infrastructure, data processing, hosting and related activities |
| Credit Institutions | L.64.91 | Financial leasing |
| Real estate and services | M.68.20 | Rental and operating of own or leased real estate |
| Real estate and services | M.68.31 | Intermediation service activities for real estate services |
| Real estate and services | M.68.32 | Other real estate activities on a fee or contract basis |
| Motor vehicles | O.77.11 | Rental and leasing of cars and light motor vehicles |
| Motor vehicles | O.77.12 | Rental and leasing of trucks |
| Sporting Equipment and Toys | O.77.21 | Rental and leasing of recreational and sports goods |
| To be allocated to the different underlying sectors it relates to | O.77.22 | Rental and leasing of other personal and household goods |
| Machinery and Equipment | O.77.31 | Rental and leasing of agricultural machinery and equipment |
| Construction and Engineering | O.77.32 | Rental and leasing of construction and civil engineering machinery and equipment |
| To be allocated to the different underlying sectors it relates to | O.77.33 | Rental and leasing of office machinery, equipment and computers |
| Other transportation | O.77.34 | Rental and leasing of water transport equipment |
| Other transportation | O.77.35 | Rental and leasing of air transport equipment |
| To be allocated to the different underlying sectors it relates to | O.77.39 | Rental and leasing of other machinery, equipment and tangible goods n.e.c. |
| To be allocated to all sectors | O.77.40 | Leasing of intellectual property and similar products, except copyrighted works |
| Motor vehicles | O.77.51 | Intermediation service activities for rental and leasing of cars, motorhomes and trailers |
| To be allocated to the different underlying sectors it relates to | O.77.52 | Intermediation service activities for rental and leasing of other tangible goods and non-financial assets |
| Recreation and Leisure | S.93.29 | Amusement and recreation activities n.e.c. |

**Questions for EFRAG SR TEG**

31 Do SR TEG members agree with the proposed approach? Please explain.

## Appendix 1: description of the three business models

### Manufacturers

*Role and Activities:*

32 Manufacturers produce goods by transforming raw materials or components into finished products. They are involved in various processes, including design, production, and quality assurance, to create a marketable product. Manufacturers may sell products directly to consumers, retailers, wholesalers, or distributors.

*Characteristics:*

33 High level of involvement in research and development (R&D) to innovate or improve products. Significant investment in production facilities, machinery, and technology. Their primary focus is on efficient production, cost control, and maintaining product quality.

### Distributors

*Role and Activities*

34 Distributors act as intermediaries between manufacturers and retailers or sometimes direct to consumers. They purchase goods in bulk from manufacturers and then sell them in smaller quantities to retailers or directly to consumers or businesses. Distributors may offer additional services such as storage, order processing, and logistics support.

*Characteristics*

35 Emphasis on logistics capability, including warehousing and transportation networks. Strong sales and marketing focus to establish relationships with retailers or business customers. Often have exclusive agreements with manufacturers to distribute products within certain geographical areas.

### Retailers

*Role and Activities:*

36 Retailers sell goods directly to the end consumer for personal or household consumption. They source products from manufacturers or distributors and offer a range of products to consumers through various channels such as physical stores, online platforms, or both (omnichannel). Retailers are responsible for the final presentation of goods, marketing, and sales to consumers.

*Characteristics:*

37 High focus on customer experience, service, and satisfaction. Utilizes marketing and consumer behavior insights to tailor product offerings and shopping experiences. Operates

in a consumer-facing environment, necessitating an understanding of retail trends and consumer preferences.

## Key Differences

*Position in the Supply Chain:*

38 Manufacturers are at the beginning of the supply chain, creating the product. Distributors serve as a bridge between manufacturers and retailers, handling the bulk movement of goods. Retailers are at the end of the supply chain, directly interacting with consumers.

*Primary Focus:*

39 For manufacturers, the focus is on producing quality products efficiently. Distributors emphasize logistics, storage, and wholesale relationships. Retailers concentrate on sales, customer service, and understanding consumer trends.

*Volume of Sales:*

40 Manufacturers and distributors typically deal in larger volumes, selling in bulk. Retailers deal in smaller volumes, selling individual items to consumers.

*Customer Interaction:*

41 Manufacturers and distributors may have limited direct interaction with the end consumer. Retailers focus heavily on engaging with consumers, offering a critical touchpoint for feedback and brand loyalty.

## Distributors

*Role and Activities:*

42 Distributors typically have a closer relationship with the manufacturer. They might have exclusive rights to market and sell a product within a certain geographic area or market segment. Beyond just selling, distributors often provide value-added services such as after-sales support, product installation, training, or customization to the products they distribute. Distributors are involved in the strategic placement of a product, often playing a significant role in the brand's marketing and sales strategy.

*Characteristics:*

43 May carry a narrower range of products, often specialized within a certain industry or for a specific type of consumer. Generally have a long-term relationship with the manufacturers whose products they distribute. Invest in marketing and promoting the products they distribute.

### Wholesalers

*Role and Activities:*

44 Wholesalers typically purchase goods in large quantities directly from manufacturers and sell them in smaller quantities to retailers, other wholesalers, or sometimes large institutional or commercial users. Unlike distributors, wholesalers usually do not focus on promoting the manufacturer's brand or providing additional services such as product customization or after-sales support. Wholesalers are more focused on the efficient handling and transportation of goods, acting as a bulk-breaking intermediary to ensure that retailers and other buyers can access products in quantities that suit their needs.

*Characteristics:*

45 Carry a broader range of products, sometimes from competing brands, offering more choices to retailers. Focus more on the logistics aspect of the supply chain, such as storage, order fulfillment, and transportation. Often operate on thinner margins, emphasizing volume and turnover rather than the value-added services.

### Key Differences

*Relationship with Manufacturers:*

46 Distributors often have exclusive relationships and rights to sell a product within a certain territory, acting almost as an extension of the manufacturer. Wholesalers typically have a more transactional relationship, buying and selling goods without exclusivity.

*Value-Added Services:*

47 Distributors may offer a range of services to both the manufacturer and the customer, including marketing, technical support, and product customization. Wholesalers generally provide fewer services, focusing more on the efficient bulk moving of goods.

*Product Range and Specialization:*

48 Distributors are likely to specialize in a narrower product range, often within a specific industry or sector. Wholesalers usually offer a wider range of products, sometimes including competing brands.

*Sales Focus:*

49 Distributors often focus on building relationships with a smaller set of customers, understanding their specific needs and how the products can meet those needs. Wholesalers sell to a broader customer base, with less emphasis on detailed product knowledge or customization.

## Manufacturing

*Key Elements:*

50 Involves the production of goods from raw materials or components using various processes, labour, and machinery. It can encompass a wide range of industries, from automotive to textiles and beyond. Energy consumption, waste management, and emission control are significant concerns.

*Sustainability Matters:*

51 Resource Efficiency: Efficient use of raw materials and energy. Adoption of circular economy principles to minimize waste and promote recycling and reuse.

52 Emission Reduction: Implementation of cleaner production techniques to reduce emissions and other pollutants.

53 Worker Welfare: Ensuring fair labor practices and safety standards are met.

## Distribution

*Key Elements:*

54 Encompasses the logistics and transportation of goods from the manufacturer to the end retailer or consumer. Includes warehousing, inventory management, order fulfilment, and transportation. Relies heavily on coordination and technology for efficiency.

*Sustainability Matters:*

55 Carbon Footprint Reduction: Optimizing routes and using energy-efficient modes of transportation to reduce greenhouse gas emissions.

56 Packaging Reduction: Minimizing the use of packaging materials or selecting sustainable packaging options to reduce waste.

57 Energy Efficiency: Implementing sustainable practices in warehousing and logistics operations, such as utilizing renewable energy sources.

## Retail

*Key Elements:*

58 Involves the sale of goods or services to the end consumer. Can be conducted through various channels, such as physical stores, online platforms, or omnichannel approaches. Customer engagement and experience are crucial elements.

*Sustainability Matters:*

59 Product Sourcing: Favouring products that are sustainably produced and ethically sourced.

60 Waste Reduction: Reducing waste through efficient inventory management and encouraging consumers to use reusable or recyclable packaging.

61 Energy and Resource Efficiency: Utilizing energy-efficient lighting and fixtures in physical stores and adopting sustainable practices in e-commerce operations.

*Key Differences and Considerations*

62 Scope of Impact: Manufacturing tends to have a more direct impact on natural resources and energy consumption, whereas distribution and retail have more focus on emissions from transportation and energy efficiency, respectively.

63 Stakeholder Engagement: Sustainability initiatives in manufacturing often involve engaging with suppliers and workers, while in distribution and retail, the focus might shift to consumers and third-party logistics providers.

64 Regulatory Compliance: Each sector may face different regulatory challenges and opportunities regarding sustainability. For example, manufacturing industries might be more concerned with emissions and waste regulations, while retail may need to focus on consumer protection and information.

65 Developing ESRS sector standards thus requires a comprehensive understanding of these sectors' unique characteristics and challenges, especially from a sustainability perspective. This understanding is essential for devising standards that are both effective in promoting sustainability and practical for businesses to implement.

## Appendix 2: NACE codes relating to leasing

| | |
|---|---|
| A.01.61 | Support activities for crop production |
| A.02.40 | Support services to forestry |
| D.35.14 | Distribution of electricity |
| D.35.22 | Distribution of gaseous fuels through mains |
| E.36.00 | Water collection, treatment and supply |
| F.43.99 | Other specialised construction activities n.e.c. |
| G.47.91 | Intermediation service activities for non-specialised retail sale |
| H.49.33 | On-demand passenger transport service activities by vehicle with driver |
| H.49.41 | Freight transport by road |
| H.49.42 | Removal services |
| H.50.10 | Sea and coastal passenger water transport |
| H.50.20 | Sea and coastal freight water transport |
| H.50.30 | Inland passenger water transport |
| H.50.40 | Inland freight water transport |
| H.52.24 | Cargo handling |
| H.51.10 | Passenger air transport |
| H.51.21 | Freight air transport |
| K.63.10 | Computing infrastructure, data processing, hosting and related activities |
| L.64.91 | Financial leasing |
| M.68.20 | Rental and operating of own or leased real estate |
| M.68.31 | Intermediation service activities for real estate services |
| M.68.32 | Other real estate activities on a fee or contract basis |
| O.77.11 | Rental and leasing of cars and light motor vehicles |
| O.77.12 | Rental and leasing of trucks |
| O.77.21 | Rental and leasing of recreational and sports goods |
| O.77.22 | Rental and leasing of other personal and household goods |
| O.77.31 | Rental and leasing of agricultural machinery and equipment |
| O.77.32 | Rental and leasing of construction and civil engineering machinery and equipment |
| O.77.33 | Rental and leasing of office machinery, equipment and computers |
| O.77.34 | Rental and leasing of water transport equipment |
| O.77.35 | Rental and leasing of air transport equipment |
| O.77.39 | Rental and leasing of other machinery, equipment and tangible goods n.e.c. |
| O.77.40 | Leasing of intellectual property and similar products, except copyrighted works |
| O.77.51 | Intermediation service activities for rental and leasing of cars, motorhomes and trailers |
| O.77.52 | Intermediation service activities for rental and leasing of other tangible goods and non-financial assets |
| S.93.29 | Amusement and recreation activities n.e.c. |