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ESRS SEC 1 - Treatment of Manufacturing and Distribution (including Leasing)

Objective

- 1 The purpose of this paper is to bring forward an overall approach to address manufacturing and distribution in the Sector Classification (SEC 1). This overall approach incorporates an approach on how to deal with leasing activities.
- 2 This paper contains two chapters:
 - (a) Manufacturing and Distribution; and
 - (b) Leasing

Background

- 3 As a general principle, the aggregation of NACE codes into sectors aims at identifying the sustainability matters and the disclosure requirements that are common to the undertakings required to apply a given standard.
- 4 Each undertaking has to cover in its reporting the material impacts, risks and opportunities (IROs) arising in the upstream and downstream value chain, when appropriate according to ESRS 1 para 26. This means that the undertaking that operates in the manufacturing sector will have to consider the material IROs arising from the business relationships with suppliers (upstream) and clients/distributors (downstream). Similarly, the undertaking that operates in the distribution sector will have to consider the material IROs arising from the business relationships upstream with suppliers (manufacturers) and downstream with clients.
- 5 Per each sector, the standard should be able to provide the relevant disclosures that pertain to the material IROs arising upstream and downstream that specific sector, so that the undertaking does not have to apply multiple standards (i.e. the standard pertinent to the activities that it operates and the pertinent to the activities that are upstream and

downstream to it). It will have to apply all the standards corresponding to the significant activities that it operates (following ESRS 2 SBM 1).

Manufacturing and Distribution: proposed approach

- 6 The EFRAG Secretariat proposes to combine in each manufacturing sector, the manufacturing activities and distribution activities in relation to a particular sector, as separate segment/subsector.
- 7 This would imply that (vertically integrated) undertakings that are active in both manufacturing of products and in their distribution, need to apply the entire sector standard applicable to them. Alternatively, if undertakings are active only in manufacturing or only in distribution of products or services, they would only apply the respective subsector of each sector standard.
- 8 The standard will also have to clarify which disclosures the distributor would have to report to cover the value chain dimension, including the IROs related to the relationships with manufacturers.
- 9 This proposal implies that the wholesale activities are being spread over the different manufacturing sectors in accordance with the table below:

NACE activities	New ESRS Sector
G.46.11 Activities of agents involved in the wholesale of agricultural raw materials, live animals, textile raw materials and semi-finished goods	Agriculture
G.46.12 Activities of agents involved in the wholesale of fuels, ores, metals and industrial chemicals	Oil and Gas Mining, Quarrying and Coal Metal Processing Chemicals
G.46.13 Activities of agents involved in the wholesale of timber and building materials	Forestry Construction and Engineering
G.46.14 Activities of agents involved in the wholesale of machinery, industrial equipment, ships and aircraft	Machinery and Equipment Other transportation
G.46.15 Activities of agents involved in the wholesale of furniture, household goods, hardware and ironmongery	Construction and Furnishings Electronics and Electrical equipment Metal processing
G.46.16 Activities of agents involved in the wholesale of textiles, clothing, fur, footwear and leather goods	Textiles, Accessories, Footwear and Jewelleries
G.46.17 Activities of agents involved in the wholesale of food, beverages and tobacco	Food and Beverages Tobacco
G.46.18 Activities of agents specialised in the wholesale of other particular products	To be assigned to the different manufacturing activities it relates to
G.46.19 Activities of agents involved in non-specialised wholesale	To be assigned to the different manufacturing activities it relates to
G.46.21 Wholesale of grain, unmanufactured tobacco, seeds and animal feeds	Agriculture Tobacco

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NACE activities	New ESRS Sector
G.46.22 Wholesale of flowers and plants	Agriculture
G.46.23 Wholesale of live animals	Agriculture
G.46.24 Wholesale of hides, skins and leather	Textiles, Accessories, Footwear and Jewelleries
G.46.31 Wholesale of fruit and vegetables	Food and Beverages
G.46.32 Wholesale of meat and meat products, fish and fish products	Food and Beverages
G.46.33 Wholesale of dairy products, eggs and edible oils and fats	Food and Beverages
G.46.34 Wholesale of beverages	Food and Beverages
G.46.35 Wholesale of tobacco products	Tobacco
G.46.36 Wholesale of sugar and chocolate and sugar confectionery	Food and Beverages
G.46.37 Wholesale of coffee, tea, cocoa and spices	Food and Beverages
G.46.38 Wholesale of other food	Food and Beverages
G.46.39 Non-specialised wholesale of food, beverages and tobacco	Food and Beverages
G.46.41 Wholesale of textiles	Textiles, Accessories, Footwear and Jewelleries
G.46.42 Wholesale of clothing and footwear	Textiles, Accessories, Footwear and Jewelleries
G.46.43 Wholesale of electrical household appliances	Electronics and Electrical equipment
G.46.44 Wholesale of china and glassware and cleaning materials	Construction materials Chemicals
G.46.45 Wholesale of perfume and cosmetics	Chemicals
G.46.47 Wholesale of household, office and shop furniture, carpets and lighting equipment	Constructions and Furnishings Electrical and electrical equipment
G.46.48 Wholesale of watches and jewellery	Textiles, Accessories, Footwear and Jewelleries
G.46.49 Wholesale of other household goods	Paper and Wood products Textiles, Accessories, Footwear and Jewelleries Sporting equipment and Toys
G.46.50 Wholesale of information and communication equipment	Information Technology Media and Communication
G.46.61 Wholesale of agricultural machinery, equipment and supplies	Machinery and Equipment
G.46.62 Wholesale of machine tools	Machinery and Equipment
G.46.63 Wholesale of mining, construction and civil engineering machinery	Mining, Quarrying and Coal Machinery and Equipment
G.46.64 Wholesale of other machinery and equipment	Machinery and Equipment
G.46.71 Wholesale of motor vehicles	Motor vehicles
G.46.72 Wholesale of motor vehicle parts and accessories	Motor vehicles
G.46.73 Wholesale of motorcycles, motorcycle parts and accessories	Motor vehicles
G.46.82 Wholesale of metals and metal ores	Metal processing
G.46.83 Wholesale of wood, construction materials and sanitary equipment	Forestry Construction and Engineering Paper and Wood Mining, Quarrying and Coal

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NACE activities	New ESRS Sector
G.46.84 Wholesale of hardware, plumbing and heating equipment and supplies	Information Technology Construction and Engineering Metal processing
G.46.85 Wholesale of chemical products	Chemicals
G.46.86 Wholesale of other intermediate products	Paper and Wood Mining, Quarrying and Coal Chemicals Textiles, Accessories, Footwear and Jewelleries
G.46.87 Wholesale of waste and scrap	Water and Waste Metal processing
G.46.90 Non-specialised wholesale trade	To be assigned to the different manufacturing activities it relates to

- 10 The EFRAG Secretariat proposes this approach, as opposed to having the distribution activities in a separate standard, as this would facilitate the identification of common sustainability matters and common disclosure requirements, based on the underlying goods/services that are distributed.
- 11 Nevertheless, there would still be a “retail-sales” sector, which would include entities that are not possible to connect to a single manufacturing sector.
- 12 This re-assignment of NACE Classes would also provide an answer to one of the most raised issues during the SEC 1 Workshops held in February 2024.

Questions for EFRAG SR TEG

- 13 Do SR TEG members agree to organise sector standards as being composed of both their manufacturing and distribution subsectors? Please explain.

Leasing

- 14 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.
- 15 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.
- 16 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.
- 17 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.
- 18 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.
- 19 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

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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.

- 20 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

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Construction and Engineering	0.77.32	Rental and leasing of construction and civil engineering machinery and equipment
To be allocated to the different underlying sectors it relates to	0.77.33	Rental and leasing of office machinery, equipment and computers
Other transportation	0.77.34	Rental and leasing of water transport equipment
Other transportation	0.77.35	Rental and leasing of air transport equipment
To be allocated to the different underlying sectors it relates to	0.77.39	Rental and leasing of other machinery, equipment and tangible goods n.e.c.
To be allocated to all sectors	0.77.40	Leasing of intellectual property and similar products, except copyrighted works
Motor vehicles	0.77.51	Intermediation service activities for rental and leasing of cars, motorhomes and trailers
To be allocated to the different underlying sectors it relates to	0.77.52	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

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

Appendix 1: Defined terms

- 1 Leasing = activities whereby one party - the lessor - conveys the right to use an asset (underlying asset) for a period of time in exchange for consideration to the lessee (see IFRS 16);
- 2 Lessee = an undertaking that obtains the right to use an underlying asset for a period of time in exchange for consideration
- 3 Lessor = an undertaking that provides the right to use an underlying asset for a period of time in exchange for consideration
- 4 Rental and Leasing activities = same meaning; no difference between rental or leasing activities
- 5 Operating lease = accounting term whereby lessor recognises the assets in its balance sheet; lessee recognises a right of use asset in its balance sheet (IFRS) or only the related lease payments (mostly local GAAP in the EU)
- 6 Finance lease = accounting term whereby lessor recognises a receivable for the consideration resulting from the lease; lessee recognises a right of use asset in its balance sheet (IFRS) or capitalises the related asset (mostly local GAAP in the EU)
- 7 Manufacturer or dealer lessors = lessor is conveying the right to use an asset produced (manufacturer) or purchased to sell or lease it out (dealer); either two or three parties are involved 1. Manufacturer/dealer, 2. Lessee and sometimes 3. Third party financing provider
- 8 Business models involved:
 - (a) Party providing financing (lessor/bank)
 - (b) Lessee receiving financing for the right to use assets for a period of time either on balance or off-balance (only local GAAP)
 - (c) Manufacturer or dealer lessors earning revenue and a margin by selling products.

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.