SEC 1 Sector Classification – Basis for Conclusions

DISCLAIMER

This Basis for Conclusions accompanies, but is not part of, Exposure Draft ESRS SEC 1 Sector Classification. It summarises the considerations of the EFRAG Writing Team and the references to other standard setting initiatives or regulations used in developing the proposed contents of the Exposure Draft.

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Sector classification

1 The sector classification is based on the following considerations:

(a) the business activities determine which sector the undertaking is operating in. Sectors share similar sustainability impacts, risks and opportunities;

(b) the impacts, risks and opportunities analysis enables the identification of the sector's sustainability matters that are material for the sector, and for which the undertaking shall report on in accordance with the sector-specific [draft] ESRS; and

(c) the identified material sustainability matters for which the undertaking shall report the Disclosure Requirements applicable to the undertaking.

2 ESRS sectors are built primarily relying on the NACE classification system with some corrections by inclusion of EU Taxonomy activities where possible.

Identification of the applicable sector-specific ESRS

3 Undertakings shall apply a sector standard for activities that:

(a) generate revenues above 10 per cent of the revenues of all their activities; or

(b) whether those activities are connected with material actual impacts or material potential negative impacts.

4 Undertakings shall also consider internal activities that do not produce revenue or are consolidated, when they are above 10 percent of the revenues of all its activities or may be connected to material impacts.

5 The application of these requirements may result in undertakings having to apply more than one sector standard.

NACE code classification

6 NACE is the Statistical Classification of Economic Activities in the European Community. It is part of the European legislative framework and through that referenced in other reporting frameworks such as the EBA Pillar 3 ESG reporting requirements. Relying on NACE codes as the basis tool for building [draft] ESRS Sector standards has the practical benefit of integrating the [draft] ESRS Sector standards into the wider European legislative and regulatory framework, leading to interoperability between all its components.

7 Business activities of undertakings are seldom monolithic, often undertakings exercise several business activities next to or complementary to each other. Scoping out a sector description is therefore a balancing act between bringing together business activities subject to similar sustainability impacts, risks and opportunities without affecting undertakings that are effectively unrelated to the core business activity of that sector. For example, many mining undertakings also process the metals they have excavated. However, most of the disclosure requirements that are set for mining undertakings are quite different than the ones defined for metal processing undertakings. An undertaking that has solely metal processing activities would not provide useful sustainability information relying on the [draft] ESRS Mining, Quarrying and Coal because its material sustainability matters are different. Instead, in case of an undertaking combining both activities it will apply both sector standards [draft] ESRS Mining, Quarrying and Coal as well as [draft] ESRS Metal processing.

Several industries in one sector standard

8 The [draft] ESRS Sector Classification is divided into 39 sectors. This contrasts for example with the number of SASB industries which are 77 in total. It implies that several [draft] ESRS sectors include more than one industry which are combined because they are subject to largely the same sustainability impacts, risks and opportunities. For example, the [draft] ESRS Sector Standard on Mining, Quarrying and Coal incorporates the segments Mining, Quarries, Coal Mining and Services to these industries. A navigation table in each [draft] ESRS Sector standard allows to determine which disclosure requirements are deemed material to which of the segments included.

NACE 2-1

9 NACE rev. 2.1 will be used for European statistics from 2025 onwards and was adopted by the European Commission in October 2022. NACE rev. 2.1 introduces new concepts at all levels of the classification and restructures a number of the existing headings. In particular, some noteworthy changes are:

(a) Insertion of implementation rules for agriculture, newspapers, journals and periodicals specifying how to classify certain of these activities. For example, using number of hours worked to classify vertically integrated agricultural activities;

(i) Expansion and adding of sustainability related activities

(ii) More detailed remediation activities, including storage of captured carbon dioxide;

(iii) Waste treatment, energy and materials recovery;

(iv) Engineering, testing, scientific research activities; …

(b) Modernising the list of economic activities eg:

(i) Crypto activities are added to the financial sector;

(ii) Addition of specialised construction activities;

(iii) More explicit description of activities in relation to biofuels;

(iv) Addition of non-scheduled passenger transport by road;

(v) Clarification that in-store and online sales are not separated as most retail activities operate both together. Ie activities are not separated based on the distribution channels but on what is being sold and the targeted customer group (retail or wholesale);

(vi) Expansion of intermediation activities relating to economic activities as such transport, tutorial activities, real estate, IT, …

(vii) 3D printing;

(viii) Expansion of medical activities; …

10 Given the first application date of NACE 2-1 (2025) EFRAG has decided to base the ESRS sector classification on this new NACE version.

EU Taxonomy

11 The EU Taxonomy is a classification system, establishing a list of environmentally sustainable economic activities and aims in steering sustainable investment and implement the European green deal. That goal is different from the development of

[draft] ESRS Sector standards which is to support the disclosure requirements that are connected to the sector(s) where an undertaking is active in.

12 As a result, EFRAG has chosen not to integrate the EU Taxonomy activities into the ESRS Sector framework but rather add references to the EU Taxonomy activities in each ESRS Sector for indicative purposes only. The detailed reasoning for doing so is explained hereafter.

13 Compared to most of the data requested under a [draft] ESRS Sector standard, the EU Taxonomy activities refer to only a (small) part of the scope of an ESRS Sector standard, leading to a very granular data output.

14 The EU Taxonomy classification, while integrating NACE, does not allow a one-to-one relationship with NACE in all cases. In about half of the circumstances the relationship is characterised by a "1 to n" relationship. It means that the same EU Taxonomy activity occurs under multiple sectors. This has the following consequences:

(a) Considering from the EU Taxonomy perspective: one Taxonomy activity can relate to multiple sectors - creating an "in between" or "supra sector" level of data higher than sector specific data, but lower than the agnostic data level; and

(b) Considering from the ESRS perspective: one sector can host multiple EU Taxonomy activities (in the current state of available EU Taxonomy activities - 20 to 30 or more) leading to breaking down sector data in a very granular format if integrated. This leads to data collection per EU Taxonomy activity.

15 The EU Taxonomy refers in some cases to NACE activities with 2 digits or 3 digits only. In contrast, ESRS Sector standards are built on NACE activities defined with 4 digits, so more detailed. As a result, one EU Taxonomy activity can refer to different underlying ESRS sectors.

16 Similar EU Taxonomy activities can affect different ESRS Sectors subject to the EU Taxonomy environmental objective involved. This implies that if a party wants to collect revenue data for climate change mitigation purposes, these data need to be separately identified from the revenue data for other environmental objectives.

17 Some EU Taxonomy activities are "unassigned" to any NACE code, which will require judgement to assign them to one or more particular ESRS Sectors.

18 When discussing the relationship EU Taxonomy and ESRS Sector standards with financial sector specialists, most agreed there was no need to align the scope of the ESRS Sector standards with the EU Taxonomy activities. Several reasons were provided for that view:

(a) The financial sector is in need for a view of the total revenue amount related to EU Taxonomy activities, but there is no need to collect individual EU Taxonomy activities revenue data per sector. As mentioned above, one sector can host 20 to 30 or more different EU Taxonomy activities;

(b) The difficulties in collection of data from different industries is not related to the relationship EU Taxonomy vs ESRS Sector standards, instead these are caused by:

(i) The large majority of loans granted to undertakings are general purpose loans, ie the bank providing the loan has no detailed view on how the undertaking spends the money, let alone if the investments done thanks to the loan relate to one or another EU Taxonomy activity, entirely or partly;

(ii) For most of the loans there is no information available which legal entity within the undertaking's overall structure will use the loan received.

(c) The EU Taxonomy encodes different activities similarly, which leads to identification of EU Taxonomy activities per environmental objective as discussed above.

19 These issues cannot be resolved within the ESRS framework but relate more to the detailed loan arrangements between financial institutions and their corporate clients.

20 A minority of the financial sector specialists consulted, while acknowledging the above concerns, noted that the ESRS Sector standards could refer to related EU Taxonomy activities for educational purposes only.

Mapping with other frameworks

21 ESRS Sector standards have been mapped with the following frameworks:

(a) Pillar III (EBA Implementing Technical Standards on Pillar III disclosures on environmental, social and governance risks);

(b) SASB industries (Sustainability Accounting Standards Board);

(c) GRI (Global Reporting Initiative); and

(d) FINREP (EBA Implementing Technical Standards on Financial Reporting according to IFRS)

22 The mappings with Pillar III and FINREP will allow banks to align the ESRS Sector requirements with their regulatory reporting requirements of their lending books.

23 The mappings with SASB industries and GRI will allow undertakings that are already applying these frameworks to situate themselves within the ESRS framework. As the development of ESRS Sector standards is still ongoing, further changes may be brought forward to these mappings, if need be.

Application requirements

24 The application requirements aim at demonstrating the use of ESRS Sector standards under different circumstances. They are hypothetical examples that allow undertakings to understand how and when to apply one or more ESRS Sector standards.