CPE ARTICLE


# Is GHG Scope 3 Emissions Reporting a Step Too Early or Too Far?

By Stephen Franciosa, CPA

**Curriculum:** Accounting and Auditing

**Level:** Basic

**Designed For:** CPAs in industry and public practice; management

**Objectives:** To discuss and provide information on topics related to environmental, social and corporate governance (ESG) issues, GHG Scope 3 emissions, climate-change disclosures, reporting requirements, mandatory and voluntary frameworks, and rules regarding climate-related transactions

**Key Topics:** SEC guidance and rules on climate-change disclosures, AICPA Center for Audit Quality (CAQ) report *Audited Financial Statements and Climate Related Risk Considerations*, three levels of emissions classified as Scopes 1, 2 and 3, Task Force on Climate-related Financial Disclosures (TCFD) disclosures, model reporting requirements, liability risk, and filing versus furnishing ESG information

**Prerequisites:** None

**Advanced Preparation:** None

In September 2021, the AICPA Center for Audit Quality (CAQ) published *Audited Financial Statements and Climate Related Risk Considerations*.[i] Below is a summary of information presented in its report:

1) On March 15, 2021, the Securities and Exchange Commission (SEC)[ii] issued a request for public input on climate change disclosures and received more than 550 unique comment letter responses to this request for input;
2) Approximately 75% of those responses supported mandatory SEC disclosure rules;
3) Accordingly, the SEC's Chair asked his staff to develop a mandatory climate risk disclosure rule proposal for the Commission's consideration by the end of the year.

So, in March 2022, the SEC proposed a rule – The Enhancement and Standardization of Climate-Related Disclosures for Investors[iii] – to respond to investors looking for more consistent, comparable information to assist them in investment decisions. Inasmuch as the reporting landscape has been inundated with an abundance of standards, codifying disclosures may well provide an ever-more coherent framework within environmental, social and corporate governance (ESG) reporting. The SEC's 510-page proposal, which is loaded with technical footnotes, has been met with over 14,000 comments.

In 2010, an SEC guidance document was created essentially to urge companies to quantify prospective compliance costs related to climate change. Public companies would be required to divulge more information about how they would respond to physical and transition threats linked to climate change and to generate specific,

not generic, information about corporate risks. And an International Financial Reporting Standards (IFRS) Practice Statement 2 issued in September, 2017[iv] indicated that external qualitative factors in which a company operates and investors' shifting societal expectations needed to be addressed when making materiality judgments and determining financial statement disclosures.

Nevertheless, the information needs of each category of users may differ and a company may not be able to meet the information needs of all "stakeholders" on all matters that may be of interest to each.

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Determining and reporting on the environmental and social costs of carbon, a metric that assigns a dollar value to the harm caused by greenhouse gas (GHG) emissions, will entail a massive expansion of federal government regulations and inevitably justify unprecedented increases in restrictions on energy, agriculture and virtually every other human activity.

In *How the World Really Works*, its author argues against "unrealistic" de-carbonization goals without a serious appreciation of current global dependence on fossil fueled energy.[v] As the evolving middle class of poor societies aspire to emulate the growth path of successful economies, their improving lifestyles will need increased energy and materials as well. The sobering reality is that energy generation and material transitions are challenging and expensive.

In a publication in 2015 entitled *Why Scientists Disagree about Global Warming – The NIPCC Report on Scientific Consensus?*[vi] its authors explain that the claim of scientific "consensus" on the causes of climate change is without merit. There is no survey or study showing consensus on any of the most important scientific issues in the climate-change debate. And while the causes of historical global warming remain uncertain, there certainly exists significant correlations regarding climate patterning over the past few hundred years.

Yet the claim that human – anthropogenic – activities are causing or will cause catastrophic global warming or climate change remains a rebuttable hypothesis, not a scientific theory and certainly not the consensus view of the science community.

Might economists be more likely to ask if the benefits of trying to "stop" global warming outweigh the benefits of providing clean water or electricity to billions of people living in terrible poverty? Wouldn't it be wiser for humanity to focus on helping people today become more prosperous and consequently more concerned about protecting the environment and be able to adapt to changes in weather regardless of causes?

In the April 2014 issue of the *Harvard Business Review* entitled The Resilient Company...How to Thrive In a Warmer World,[vii] one author reassures that companies seem to have a clear vision of how climate change and resource scarcity will affect their prospects and ability to reach long-term goals while taking into account the best environmental data available. And about 90% of the firms in the S&P 500 publish voluntary reports disclosing statistics, including carbon emissions and how much renewable energy they use. Yet only 16% report similar metrics in regulatory filings. The issue is whether companies, regulators and environmentalists can agree on the proper way to account for carbon emissions being recommended in the proposed SEC rule.

There is much attention being given to model reporting requirements, while no U.S. accounting rule spells out how to account for climate change or environmental impact. And rules would require judgments and assumptions that could contemplate environmental considerations.

There are assorted Accounting Standards Codifications (ACSs) that already address risk and uncertainties, environmental obligations, and contingencies. Material matters currently need to be disclosed in financial statement footnotes. Organizations already consider regulatory, legal and contractual obligations when addressing contamination remediation.

While six major mandatory and voluntary frameworks addressing climate change currently exist, investors appear to be embracing Task Force on Climate-related Financial Disclosures (TCFD) as part of ESG evaluations. The TCFD 2021 Implementing Recommendations for non-financial companies states that disclosures should present relevant information, be specific and complete, and be comparable for organizations within a sector. Companies will also be asked to disclose opportunities that could arise from a changing climate and corresponding market and policy shifts.

The challenge regulators and corporate officials recognize is identifying which measurements are necessary, and how to set requirements that are flexible enough to generate specific and not just generic information about corporate climate risks.

Currently, the Financial Accounting Standards Board (FASB) intends to craft rules regarding climate-related transactions inasmuch as generally accepted accounting principles (GAAP) literature is vague. In his research report in 2018, Baruch Lev of the NYU Stern School of Business opined upon *The Deteriorating Usefulness of Financial Information and How to Reverse It*.[viii] His comments include:

1) The FASB rules produce financial statements that virtually no one understands;
2) Financial reporting has hardened into a compliance exercise instead of producing the best information to constituents;
3) There is a growing concern about disclosure overload; and
4) Many investors don't understand the accounting or care.

In July 2020, Ernst & Young (EY) published the results of an investor survey entitled *How Will ESG Performance Shape Your Future*,[ix] which indicated that ESG factors have never been more pressing. The majority of institutional investors are signaling a desire for a more disciplined and rigorous approach to evaluating and more credibility on corporates' nonfinancial performance.

Strategies may include criteria such as how an organization is managing financially material ESG issues. Furthermore, investors are seeking disclosures that are clear and transparent, founded on high-quality data, and produced using robust and reliable processes and systems.

Finding value in "external assurance" of the robustness of an organization's planning for climate risk will enable investors to develop more credible and nuanced approaches to understanding what influences long-term value. Naturally, there would be a significant value in third-party assurance being independent across all "scopes" developed in the SEC's proposed rule.

Now back to the proposed SEC rule, which identifies reporting on three levels of emissions classified as Scopes 1, 2 and 3.

Scope 1 emissions are direct emissions from an enterprise's owned or controlled sources. Scope 2 emissions are indirect emissions from the purchase of generated energy. Presumably many companies will evaluate and report on their Scope 1 and 2 emissions; apparently, an easy enough exercise … relatively speaking.

For entities that may more extensively affect climate change, climate-related matters will hardly be limited to aspects of an entity's own operations. Scope 3

**The challenge that regulators and corporate officials recognize is identifying which measurements are necessary …**

emissions is about what others do … it is the result of uncontrollable activities from assets that are not owned by the reporting organization, but that the organization indirectly impacts by virtue of its supply chain.

Scope 3 emissions disclosures fall into two groups. The first group called upstream includes goods and services purchased and consumed. The second group is called downstream, which are the goods and services that a business produces and sells. Accordingly, the entire supply chain would almost always count towards a large part of any company's emissions.

Crunching greenhouse gas numbers requires detailed information from multiple companies in the supply chain that could be spread throughout the world. Given that Scope 3 emissions will inevitably be a significant part of overall GHG emissions, the challenge of accounting, let alone providing assurance on emissions, will be formidable at best. Calculating emissions promises to be more complex than traditional calculations for financial accounting.

So, the drive towards consistent, comparable and reliable information begs the question: who is spearheading the drive to ESG disclosures since ESG seems anchored in the idea that **anyone and everyone is a stakeholder in everything**? A May 10, 2022 *WSJ* article entitled "Stakeholder Capitalism Criticized"[x] addressed the creeping liberal bias inside a three-sided group of massive investment firms, which is characterized as an ideological cartel! To illustrate, the article presents one high-profile example of a group seeking board seats on a small hedge fund that then sided against Exxon Mobil regarding the company's climate-change strategy.

More alarmingly, *The Economist* on April 23rd, 2022 published an article "Lawsuits Aimed at Greenhouse-gas Emissions are a Growing Trend."[xi] It states that while the Paris Agreement of 2015 brought a greater awareness of climate change, it likewise committed governments to keeping global temperature increases below 2 degrees Celsius. The agreement also made things more actionable in a way that they had not been considered before, thus causing increased investigations and litigations.

Lawsuits related to climate change could potentially become material risks. This risk of litigation would now need to be factored into an organization's credit risk. Might ill-calculated Scope 3 emissions precipitate heightened shareholder activism and frivolous lawsuits?

Ironically, a *WSJ* article on May 9, 2022 stated that "ESG Fund Managers Find 'Greenest" Stocks Too Pricey"[xii] and they are putting their money in companies that are still working on their ESG credentials. These oft-called fund improvers have lower ESG ratings and are typically seen as undervalued. Identifying these improvers varies. It includes not only a blend of fundamental analysis but also those whose management has committed to sustainability.

Notably, Berkshire Hathaway doesn't report climate-related risks. In a three-page sustainability report, its energy unit states that it strives to achieve net-zero GHG emissions but it put no date on the target.


**Crunching greenhouse gas numbers requires detailed information from companies in the supply chain that could be spread throughout the world.**

Add to this that BlackRock now states it won't back shareholder climate proposals it considers too prescriptive (that is, too dogmatic, authoritarian, rigid … take your pick!). BlackRock Investment Stewardship intimated it would not back stockholder proposals that try to micromanage companies and their climate-change programs but would instead support companies as they address material business challenges they face, including the decades-long transition to a low-carbon economy.

This past March, The Bureau of Investigative Journalism found that Blackrock and several banks had quietly downplayed their environmental commitments so they could keep doing business with deep-pocketed U.S. oil states.[xiii] One U.S. senator told the bureau, "If they have not been honest with investors about their climate policies, then this is a matter for the SEC to look into."

In response to the SEC's initial request for comment, on July 11, 2021, the American Petroleum Institute (API) expressed – 12 pages – the concerns of its members.[xiv] API represents all segments of the U.S. oil and natural gas industry. Within its comprehensive response, it addressed the concept of **filing** versus **furnishing** ESG information. Filed disclosures would be subject to the Securities Act of 1933. Alternatively, furnished information could be expanded to add additional perspective and context. Furnished information would still be covered by existing federal securities laws, including anti-fraud provisions.

In its response to the SEC, The National Investor Relations Institute (NIRI) stated that calculating Scope 3 emissions would be subject to differing methodologies, subjective judgments and widespread inaccuracies … since there is no widespread consensus among companies and investors about the many different climate change metrics and risks.[xv]

The response from NIRI's president and CEO went on to say that under the proposed rule, companies would be subject to numerous mandatory requirements and a much higher level of liability than the status quo. In a scholarly article entitled "Indirect Emissions Disclosures Are Important but Tricky"[xvi] its authors noted that reporting on Scope 3 GHG emissions may give rise to higher liability risk for companies compared to other climate disclosures, since the reporting company cannot ensure the quality and accuracy of the information that it gets from third parties.

The National Association of Manufacturers suggested that the best way to protect the businesses they represented would be to strike Scope 3 from any final rule.[xvii] The American Farm Bureau stated "this is an end-run around legislation to get companies to report certain climate change information in their financial reports."[xviii]

In dissenting on the proposal, a sole SEC commissioner wrote, "We are not the Securities and Environment Commission – at least not yet."[xix] She likewise stated prophetically that she was grateful to the many commentators who had responded to the initial request for public comment and for the greater number of comments expected in response to the proposal.

In conclusion, this article begs the pertinent question, "Is GHG Scope 3 emissions reporting a step too early or too far?"

***About the Author:*** Stephen Franciosa, CPA, is a sole practitioner on City Island in the Bronx, NY. His practice consists primarily of accounting and audit services to small non-profits. He is a member of AICPA, NYSSCPA and NCCPAP. He has taught accounting and auditing courses at CUNY – Lehman College and Iona University.

***Endnotes***

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# CPE ARTICLE: IS GHG SCOPE 3 EMISSIONS REPORTING A STEP TOO EARLY OR TOO FAR?

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**1. How many SEC commissioners dissented to the proposal on March, 2022 – The Enhancement and Standardization of Climate-Related Disclosures for Investors.**

a. One c. None
b. Two d. All

**2. The SEC created a guidance document to urge companies to quantify progressive compliance costs related to climate change in what year?**

a. 2022 c.2017
b. 2021 d.2010

**3. According to the article, the SEC should develop mandatory climate-change disclosures:**

a. As soon as possible
b. Gradually over the next 10 years
c. No timeframe recommendation is being made
d. Only if they are material

**4. The SEC's proposal would require companies to reduce the negative effects on climate:**

a. No matter the cost
b. Only if costs are reasonable
c. Only when stakeholders make a formal demand to have costs disclosed
d. The SEC has not mandated a, b or c

**5. The American Petroleum Institute (API) in its comprehensive response on July 11, 2021, to the SEC's request for comment:**

a. Addressed the concept of filing disclosures of ESG in formation subject to the Securities Act of 1933
b. Addressed the concept of furnishing expanded ESG in formation to add additional perspective and context that would still be covered by existing federal securities laws, including anti-fraud provisions
c. Both a and b
d. Neither a nor b

**6. Which of the following statements is correct?**

a. Scope 1 emissions are direct emissions from an enterprise's owned and controlled sources
b. Scope 2 emissions are indirect emissions from the purchase of generated energy
c. Scope 3 emissions include goods and services purchased and consumed and goods and services that a business produces and sells
d. All of the above

**7. One work/author cited in the article is of the opinion that:**

a. The FASB rules continually improve upon the understanding of financial statements
b. Financial reporting has hardened into a compliance exercise instead of producing the best information for stakeholders
c. Investors understand accounting and do care about the information presented and disclosed in financial statements
d. There is no disclosure overload in financial statements

**8. According to the article, which statement is false?**

a. Only a small minority of institutional investors desire a more rigorous approach to evaluating a corporation's nonfinancial performance
b. The information needs of each category of users should not differ significantly and any company should be able to easily provide the informational needs of all stakeholders
c. Regulators have already identified which ESG measurements are necessary
d. a, b and c are each false

**9. Which of the following statements is correct?**

a. There already exists assorted Accounting Standards Codifications that address risks and uncertainties
b. Material matters currently need to be disclosed in financial statements
c. Organizations already consider assorted obligations when addressing contamination remediation
d. All of the above

**10. Berkshire Hathaway Inc. is an example of a company that always reports climate-related risks.**

a. True
b. False

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