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Emission Disclosures: Sunlight on Climate Risks

What role do financial statements play in climate change?

By Ryan James Boyle

My first corporate boss had a phrase he relied upon so often that he framed a printout on his office wall: “You Can’t Manage What You Can’t Measure.” The phrase has often come back to me when considering environmental topics. Assessing the scope and magnitude of climate risk is daunting; it’s hard to tell where to start.

The U.S. Securities and Exchange Commission (SEC) has proposed a rule to dramatically expand climate risk reporting. (506 pages **in full**, also **summarized here**.) Whether or not it makes climate risk manageable, the SEC intends to support measurement of companies' climate exposures.

The SEC governs financial statements, the filings made by all U.S. publicly-traded companies. Since the 1970s, SEC guidance has required businesses to mention major environmental costs or risks to their businesses, like the costs of compliance with emission regulations and disaster risks to their locations. The new proposal dramatically increases the scope of this requirement.

The rule calls for reporting entities to list as much environmental detail about their businesses as they can. Any climate-related risk that could affect **costs or revenues** by 1% must be detailed. All Scope 1 and 2 emissions (made directly by the company and from its purchased utilities) would have to be reported. Companies with emissions targets would have to detail not just their goals, but measured progress and a plan to achieve them.

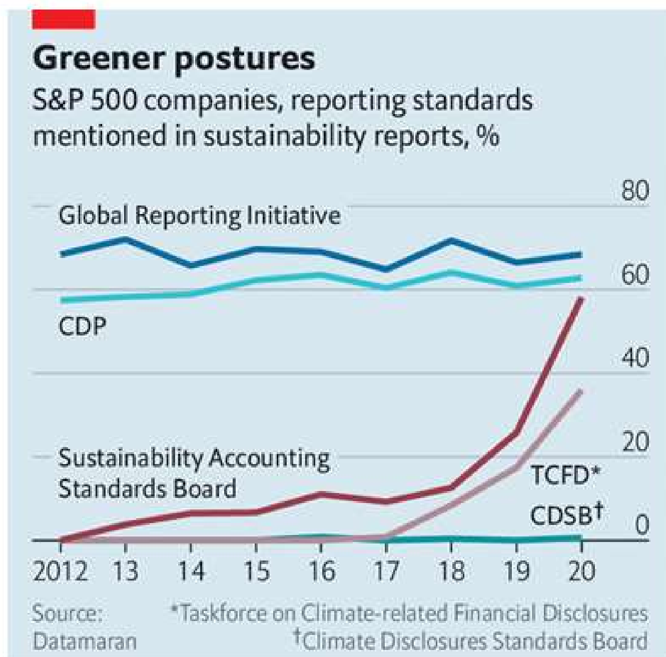
The requirements are less stringent for Scope 3 emissions, those that are produced elsewhere in the company's value chain. This is the broadest and most difficult category of emissions to measure. Companies must report Scope 3 emissions only if they are "material" or if the company has a reduction target. For some entities like financial institutions, direct emissions are negligible, but emissions from financed activities can be substantial.

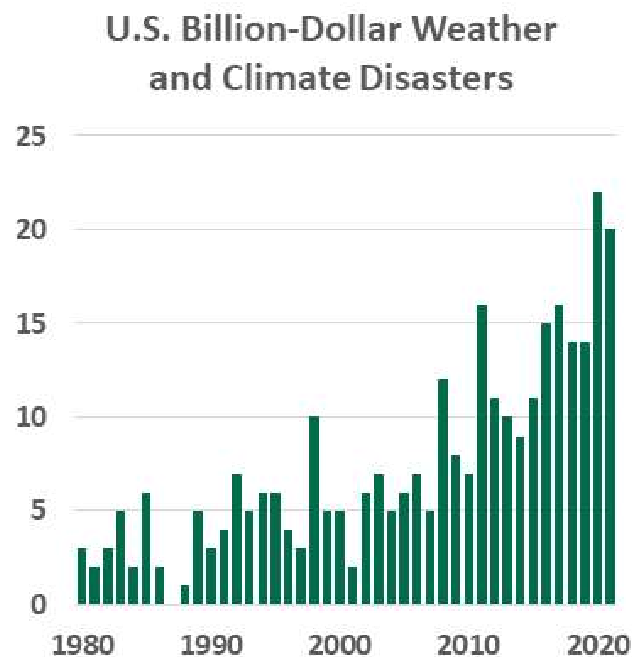
Environmental disclosures are not entirely new. Many companies publish corporate social responsibility reports, highlighting their green efforts, with wide editorial discretion. Working groups like the **Carbon Disclosure Project** and **Task Force on Climate-related Financial Disclosure** have established voluntary reporting standards. The SEC's proposal **builds on those efforts**, making them more uniform and mandatory.

The proposal is not yet a policy, and it could be stopped in the courts. The requirement is a stretch of the SEC's statutory authority, and SEC policies are subject to legal challenge, with a precedent that any rule must have benefits that outweigh its costs.

The new costs to reporting entities are manifest. Companies would need to develop practices to routinely compute their emissions, and have those figures validated independently. Aside from a safe harbor for Scope 3 emissions, any error or omission in reported data will create litigation risk.

Measurement and disclosure are first steps in climate regulation.





Sources: Economist, NOAA, Haver Analytics

The benefits are less tangible. The upside to reporting firms is unclear, as emission reductions do not directly factor into valuation. ESG investors already have a range of information available to them, which allows them to steer their capital. The SEC only has purview over US-listed public companies; the proposed rule may lead to an unintended consequence of polluting activities being pushed to privately-held or offshore entities.

The draft rule is now in a 60-day comment period, and comments are expected to be voluminous. If finalized this year, it would take effect for the largest firms for their fiscal year 2023 annual reports (published in 2024), with smaller firms to follow.

Climate risks are growing, as are investors' appetites for informed decisions of ESG matters. Uniform disclosures will help better measure environmental risks, but managing them will require tangible, legislated actions which are not under consideration today. As with other areas of endeavor, data can help measure the problem, but human beings are still needed to solve it.

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