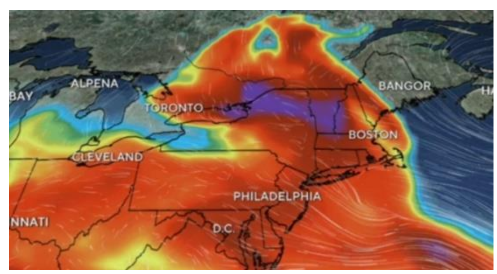
SEC Final Climate Disclosure Rule:

Scope 3 In or Out? It Won't Matter!

Memo to those hoping that an SEC will not require disclosure of Scope 3 Greenhouse Gas (GHG) emissions in a final climate disclosure rule: **It won't matter**. Your organization will need to calculate and report Scope 3 emissions. It will be a massive undertaking. Continuing to postpone effort much longer may cost you, in terms of direct costs and indirect impact on company value. Read to understand the folly of inaction.

SEC proposed climate disclosure rules in March 2022 – fifteen months ago, at this writing. Several provisions caused uproar and gnashing of teeth; perhaps none so much as the requirement to disclose Scope 3 greenhouse gas (GHG) emissions. Many have deferred meaningful efforts to compile Scope 3 emissions, often expressing three types of hope.

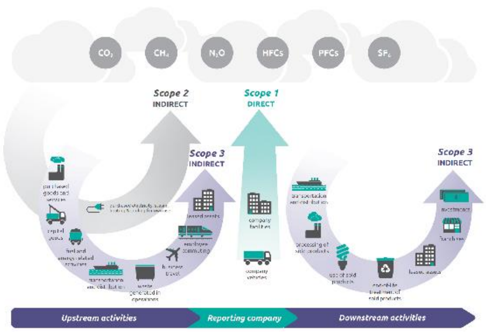
Hope #1: The SEC won't issue a final rule. DHC[1] believes the SEC will. The Task Force on Climate-Related Financial Disclosures (TCFD) was founded in 2015 to address risk posed by climate change. TCFD was founded by the Financial Stability Board. It was not founded by the Sierra Club, Greenpeace, the United Nations, or a social NGO. Climate change is an existential threat to the economies of the world as we know it.



It could be an existential threat to some companies, business units, suppliers or customers. Climate change creates risk that can affect a company's prospects for access to capital, and financial performance. The International Financial Reporting Standards Foundation (IFRS) created the International Sustainability Standards Board (ISSB), merging several prominent legacy organizations into it. ISSB released final disclosure standards in late June 2023, including S2 – Climate-Related Disclosure standard. The SEC is in the business of providing meaningful information *to investors*. FSB understood that climate change is not a belief. It's a reality, it will affect companies, and it will affect them in different ways. Disclose, please.

[1] Douglas Hileman Consulting LLC (DHC) helps clients with Sustainability governance, compliance, risk, reporting, and audit readiness. The perspectives are mine alone. I am neither an attorney nor a CPA, and am not privy to any inside information.

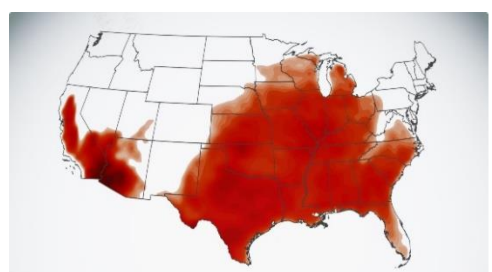
Hope #2: Scope 3 won't make it to the SEC final rule. This may or may not happen. If so, it will provide limited relief – and maybe none.



ISSB's S2 Climate Disclosure Standard includes the requirement to disclose Scope 1, Scope 2 and Scope 3 GHG emissions[2]. Like its relative ISSB S1, the Climate Disclosure Rule emphasizes the concept of value chain throughout (the term appears 51 times). Even if your company is based in the U.S., only has operations in the U.S. – even if privately held – chances are that your customers purchase your goods or services. You are their Scope 3. You may transport or distribute your goods to customers; that's <u>their</u> Scope 3 (and part of yours as well).

Hope #3: Lawsuits will postpone or stop it. The SEC climate disclosure rule will immediately be faced with an onslaught of litigation. This could stall implementation (let alone enforcement). It could eliminate unwelcome provisions – maybe the rule altogether? Consider challenges to the Dodd-Frank Conflict Minerals rule as a possible precedent. Litigation was successful in deferring a [statutory] requirement to procure and submit an Independent Private Sector Audit. A key premise for the lawsuit was that companies could not be compelled to use a specific term – "Not Found to be DRC Conflict Free" – as a violation of free speech. The requirements to prepare and submit a Conflict Minerals Report remain; over 1,000 CMRs were submitted for CY 2022 by the May 31, 2023 deadline.

The proposed SEC climate disclosure rule does not require regulated entities to reach conclusions, or to use specific terms ("carbon neutral" or "net zero"). Global capital markets will demand complete, accurate, verifiable data on GHG emissions, including Scope 3. Customers will demand to know your share of their Scope 3 emissions. If you do not meet customer expectations, you may lose customers – a risk that should be considered in the risk assessment process. But that's another section of the Climate Disclosure Rule.



[2] See IFRS S2 Climate-Related Disclosures, June 2023; paragraph 29 (a).

What WILL Matter

A requirement to provide Scope 3 GHG emissions is highly likely to find your organization one way or another. In fact, it is likely to find you several different ways. It could come from the SEC. It could come from providers of capital outside the U.S. – who use ISSB. It could come from customers or companies in your value chain. Requests via this channel will likely vary: emissions from your consolidated entity, from the division (or facility) that provides products they buy; emissions for a specific Scope 3 emissions category.

So, what to do?

1) Determine Scope 3 categories that are most relevant to you and your business partners.

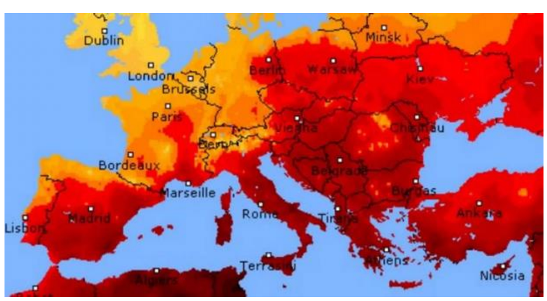
2) Begin/ improve processes, systems and controls to compile relevant data.

3) Recognize that judgment and estimates are part of this process. Devote a credible level of effort to both, and document the basis for everything.

4) Become familiar with (and use!) relevant standards and reference documents, including:

    - those that pertain to GHG emissions in particular, notably those published by the GHG Protocol;
    - those relevant to your industry and processes; and
    - those that facilitate structure, connected information, and relationships to financial reporting and disclosures. COSO's supplemental guidance on Internal Controls over Sustainability Reporting[3] is a notable example.

5) Begin yesterday.



[3] This supplemental guidance, authorized by the COSO Board, has received remarkable uptake since its release in June 2023. Douglas Hileman is a named author of this document - the only non-CPA and the only Sustainability specialist.

About Douglas Hileman Consulting LLC

Douglas Hileman helps clients with Sustainability compliance, risk, programs, reporting and disclosures and audits. He is an author of COSO's supplemental guidance "Achieving Effective Internal Control over Sustainability reporting (ICSR)", which has taken the accounting and audit community by storm. He is the only non-CPA and only ESG specialist on the author team. He has over four decades of experience in operations, corporate, management consulting, Big 4 firm experience (including during early Sarbanes-Oxley years), and with his consultancy. He was on the Volkswagen Monitor Team for three years, as the senior environmental management/ auditing specialist, working on behalf of the DOJ. He is in demand for training, workshops, and presentations at conferences. One distinction is his ability to bridge the gap between traditional financial reporting professionals (Accounting, Internal Audit, Finance) and functions responsible for much of the Sustainability data and information (Environmental, HR, IT, Operations, Procurement, Real Estate, etc.). More at www.douglashileman.com.