# Trends Show Companies Are Ready for Scope 3 Reporting with U.S. Climate Disclosure Rule

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In March 2022, the United States Securities and Exchange Commission (SEC) proposed a new climate disclosure rule which would require companies registered with the SEC to disclose climate-related information so that investors can consider climate-related financial risks when making investment decisions. This includes physical risks from the impacts of climate change and transition risks from moving to a lower carbon economy, including pressure to reduce greenhouse gas (GHG) emissions.

The proposed rule would require companies to disclose scope 1 emissions (from direct sources) and scope 2 emissions (from purchased electricity, heat or steam), whereas it would require disclosure of scope 3 emissions (from other sources in the value chain) only when deemed material to investors or when the company has emissions targets that encompass scope 3 emissions. **But scope 3 emissions are an important source of climate-related financial risk across the business value chain and should be reported by all registrants under the SEC proposed climate disclosure rule.**

Scope 3 emissions account for the largest share of most companies' GHG emissions, and investors report that scope 3 estimates are useful for informing their financial decisions, reflecting the SEC's definition of financial materiality. The SEC's proposed approach aims to "balance the importance of scope 3 emissions with the potential relative difficulty in data collection and measurement." But many companies already estimate scope 3 emissions, and the SEC's procedures for disclosing material assumptions and uncertainties in financial accounting could be applied to scope 3 emission estimates.

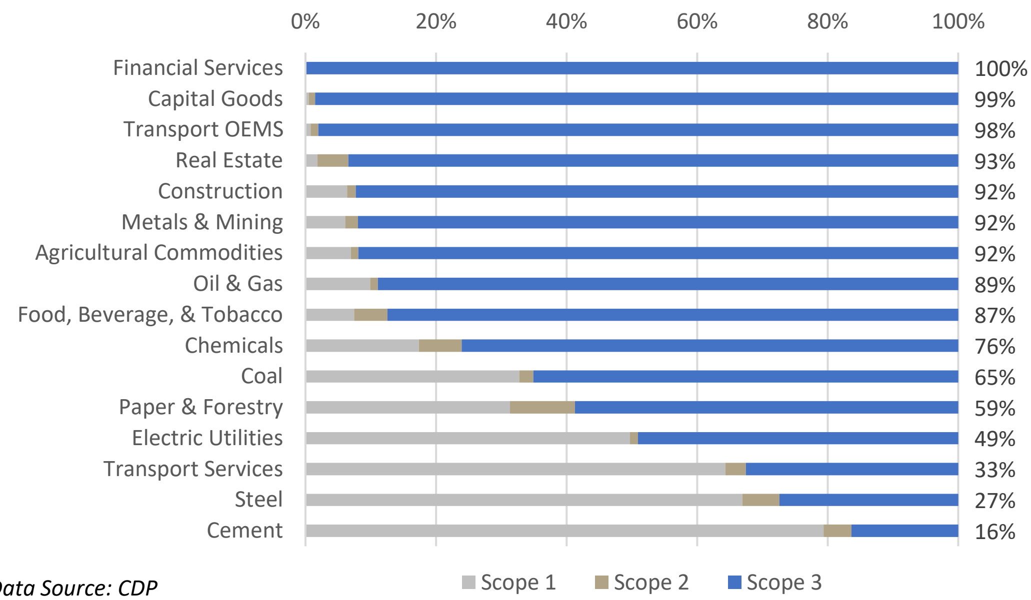
Disclosure of scope 3 estimates and the associated uncertainty is essential for understanding companies' full exposure to transition risks. Scope 3 emissions also contribute to climate change, causing harm to nature and humans. While this concept of double-materiality — accounting for climate impacts on a company *and* a company's impact on the climate — is included in European disclosure requirements, the SEC has signaled a reluctance to deviate from its singular focus on financial materiality.

However, each fraction of a degree increase in global average temperature increases companies' exposure to physical risks. The SEC's limited approach to scope 3 reporting may thwart emissions reductions by discouraging companies from setting (and reaching) scope 3 targets, resulting in further contributions to climate change and increasing companies' exposure to climate-related physical risks.

## Scope 3 emissions account for 75% of companies' greenhouse gas emissions on average

The CDP estimated that scope 3 emissions account for an average of three-quarters of a company's emissions. But the importance of scope 3 emissions varies considerably by sector and can approach 100% of a company's emissions (scope 3 emissions were 99.98% on average for companies in the financial services sector). Other studies show that the supply chains of eight sectors account for half of the world's GHG emissions and provide evidence that scope 3 emissions from energy-intensive industries are increasing faster than their scope 1 and 2 emissions.

**Contribution of Scope 3 Emissions to Total GHG Emissions by Sector**



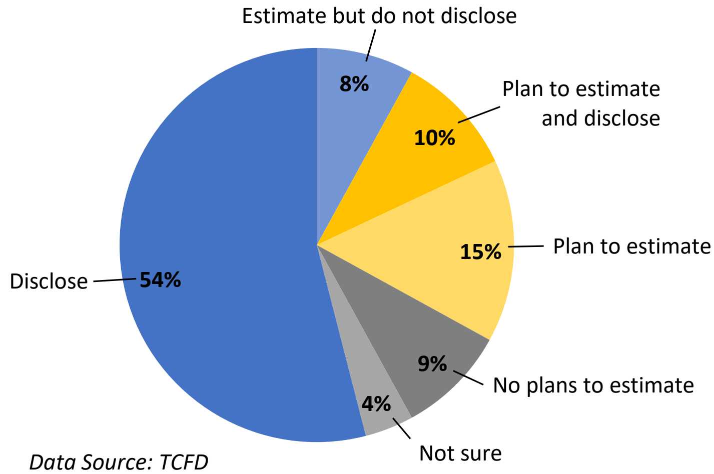

*Data Source: CDP*

## Scope 3 emissions are too important to omit

Arguments against reporting scope 3 emissions focus on data collection and accounting challenges (e.g., lack of primary data, a reliance on industry average data, or potential double-counting of emissions between reporting entities) and the inability to control the actions of value chain partners. Counterarguments emphasize the importance of scope 3 emissions in understanding climate-related financial risks, facilitating actual emissions reductions within the value chain, preventing companies from claiming lower emissions and related liabilities by outsourcing carbon intensive activities (i.e., 'moving' emissions from scope 1 or 2 to scope 3), and preventing companies from skirting responsibilities to be transparent to their shareholders about their overall risk exposure, which is especially relevant for industries with a majority of their emissions classified as scope 3. Proponents also point to existing scope 3 accounting practices and advancements in scope 3 data collection as enablers of scope 3 disclosure.

The debate over importance versus accounting challenges for scope 3 emissions was evident in the 2021 Task Force on Climate-related Financial Disclosures (TCFD) public consultations on its proposed guidance on climate-related metrics, targets, and transition plans. TCFD surveyed and obtained feedback from 100 climate-disclosure users, 106 climate-disclosure preparers, and 46 other respondents. Nearly all (95%) users responded that scope 3 emission disclosures are useful for decision-making and most preparers (87%) responded that they estimate or plan to estimate scope 3 emissions.

**Scope 3 Disclosure Practices and Intentions of Climate Disclosure Preparers**



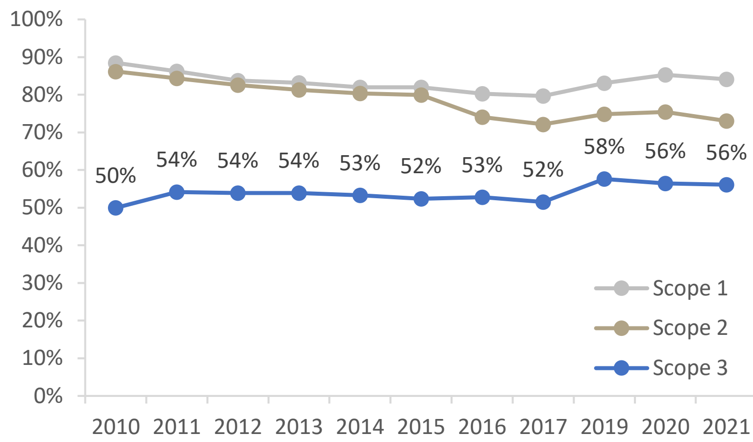

*Data Source: TCFD*

Preparers identified scope 3 emissions as one of the more difficult metrics to disclose, with 39% specifying it as very difficult, 42% as somewhat difficult, and only 20% as not at all or not very difficult. The most common challenges identified included difficulty accessing relevant data (83%), challenges selecting or applying calculation methodologies (60%), and lack of internal expertise or resources for calculating scope 3 emissions (29%). Almost all respondents (90%) expressed support for scope 3 disclosure (47% irrespective of materiality and 43% based on materiality).

## Despite data challenges, more than half of disclosing companies report scope 3 emissions estimates

As part of a research study commissioned by World Resources Institute (WRI) — a co-convener of the GHG Protocol — we evaluated the current scope 3 accounting practices of companies that disclosed climate information to CDP's global environmental disclosure system and agreed to their data being publicly available. The percentage of companies reporting scope 3 emissions for at least one scope 3 category increased from 50% in 2010 to 56% in 2021. As seen in the TCFD consultations, more companies estimate emissions than disclose emissions. We would therefore expect the percentage of companies that estimate scope 3 emissions to be higher than the percentage that disclose emissions to CDP.

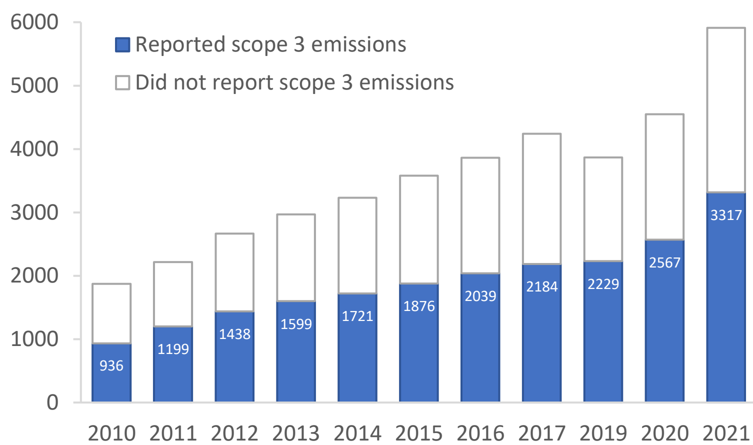
**Percentage of Disclosing Companies that Report Scope 3 Emissions**




*Data Source: CDP*

While the rate of scope 3 reporting has increased slightly, the actual number of companies that reported scope 3 emissions in the public CDP dataset has increased from 936 companies in 2010 to 3,317 companies in 2021. Since fewer than half of companies that disclose climate information to CDP agree to have their data distributed, the actual number of companies reporting scope 3 emissions to CDP would certainly be higher, and perhaps double what is presented here.

**Number of Companies Reporting Scope 3 Emissions to CDP**



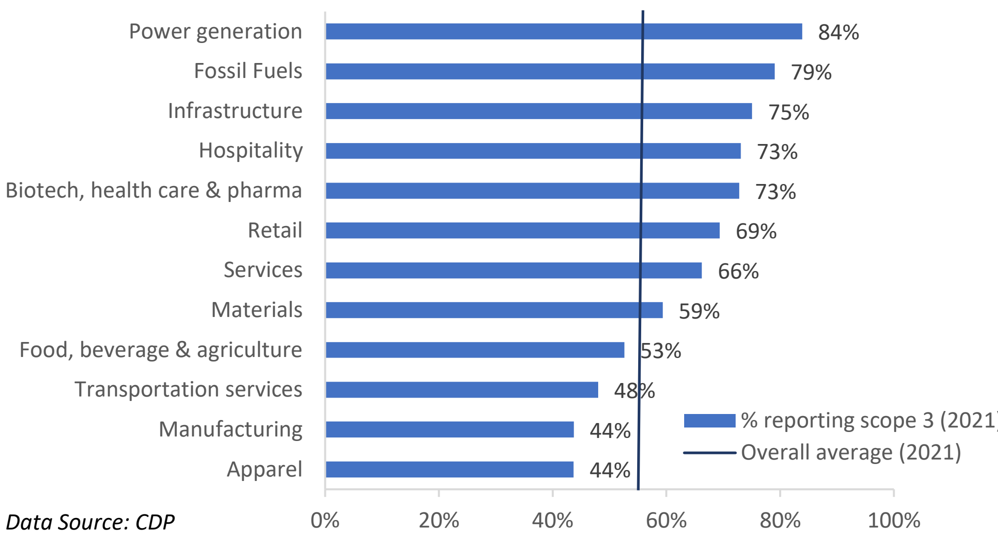

*Data Source: CDP*

## Most companies report scope 3 emissions in many industries but not in several critical industries

In most industries, the overall rate of scope 3 reporting is higher than the CDP average. In 2021, the highest rate of scope 3 reporting was by companies in the power generation industry, with 84% of companies reporting emissions for one or more scope 3 categories. In contrast, the manufacturing industry drives down the overall rate of scope 3 reporting because it represents the largest portion of companies disclosing to CDP (38%) but has a lower scope 3 reporting rate (44%).

Particularly troubling is that some industries with lower rates of scope 3 reporting are associated with supply chains that have been found to account for half of the world's GHG emissions, including food, fashion, freight, as well as electronics and automotive (which fall under the manufacturing industry in CDP's dataset). With the SEC's proposed discretionary approach to scope 3 reporting, some companies with carbon-intensive value chains may continue to omit scope 3 emissions from their climate disclosures, thereby failing to provide complete information about exposure to climate-related financial risks.

**Scope 3 Reporting by Sector**



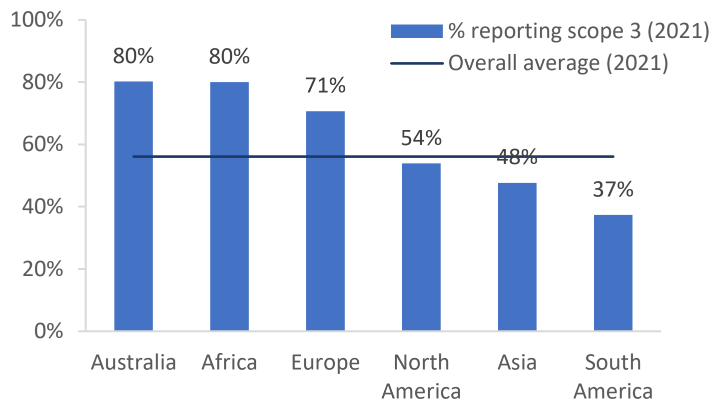

*Data Source: CDP*

## US companies report Scope 3 emissions at a lower rate than their counterparts

The percentage of companies that report scope 3 emissions also varies by geography. Companies from other Global North regions are more likely to report scope 3 emissions in their climate disclosures than companies in the U.S.

In 2021, 71% of European companies and 80% of Australian companies that disclosed emissions to CDP reported emissions for one or more scope 3 categories. The lower global average reporting rate is heavily influenced by companies in the U.S., China, and Brazil, which have a high number of disclosing companies, but a lower rate of scope 3 emissions reporting. Companies in the U.S. accounted for the highest percentage (19%) of disclosing companies and had a scope 3 reporting rate of 56%; companies in China accounted for the second highest percentage (14%) of disclosing companies and had a scope 3 reporting rate of 27%; and companies in Brazil accounted for the fifth highest percentage (6%) of disclosing companies and had a scope 3 reporting rate of 37%. Consequently, U.S. companies may be at a disadvantage with investors who are increasingly concerned with climate-related financial risks, particularly risks associated with transitioning the economy away from fossil fuels.

**Scope 3 Reporting by Continent**




*Data Source: CDP*

## The SEC should require scope 3 emissions reporting to better inform investors of climate-related financial risk

Regardless of judgements about financial materiality or type of targets set, the SEC should require scope 3 emissions disclosure to provide investors with more complete information about their exposure to climate-related financial risks. These risks may otherwise remain hidden in companies' value chain.

Companies should report their largest sources of risk, and for many companies, this includes scope 3 emissions. Although scope 3 emissions estimates require assumptions, rely on imperfect estimation methods, and are uncertain, this is no different than the uncertainties embedded in many financial metrics currently disclosed by companies.

For over two decades, companies have been gaining GHG accounting experience, and thousands of companies now report scope 3 emissions to CDP every year. Investors should not be denied information about an important source of financial risk because data collection may be difficult. Instead, the SEC should require scope 3 emissions reporting by all its registrants.