CLEARY GOTTLIEB

ALERT MEMORANDUM

SEC's Proposed Climate-Related Disclosure Rules: The Climate Note to Audited Financial Statements

April 5, 2022

On March 21, 2022, the U.S. Securities and Exchange Commission issued for public comment a rule proposal that, if adopted, would require reporting companies to provide certain climate-related information in their registration statements and annual reports filed with the SEC. Specifically, the proposed rules would require:

(1)

A new section in annual reports and registration statements titled "Climate-Related Disclosure," which would include climate-related governance, risk, business impacts, targets and goals and other related disclosures.

(2)

Within that section, disclosure of the registrant's Scope 1, Scope 2 and, if material, Scope 3 greenhouse gas (GHG) emissions, together with an attestation report from an independent GHG emissions expert covering the Scope 1 and Scope 2 emissions disclosures.

(3)

A new note to a registrant's audited financial statements that provides climate-related metrics and impacts on a line-item basis.

This memorandum addresses the ***third point*** above – the proposed amendments to Regulation S-X to require a new footnote in audited financial statements – and concludes with some general takeaways and possible issues for inclusion in comment letters on the proposal. Please see the other two memoranda in this series for a discussion of the GHG emissions and attestation report disclosure requirements and the Regulation S-K governance, business, risk and targets disclosure requirements described above.

The comment period for the proposed rule is quite short: comments will be due on May 20, 2022, or 30 days after the proposal is published in the Federal Register, whichever is later. We expect that the SEC will aim to release the final rules before the end of 2022.

I. Proposed Changes to Regulation S-X

A. Introduction

The SEC's climate-related disclosures proposal would create a new Article 14 of Regulation S-X requiring a registrant to include specific climate-related financial disclosure in the notes to its audited financial statements.[1] Regulation S-X contains requirements for financial statements that are included in registration statements, periodic reports and other filings under the Securities Act of 1933 and the Securities Exchange Act of 1934. It applies regardless of whether the registrant uses the forms for domestic issuers (e.g., Form 10-K) or for foreign private issuers (e.g., Form 20-F), and regardless of whether the registrant uses U.S. GAAP or IFRS. Proposed Article 14 would not apply to interim financial statements.

Because these disclosures would be located in the audited financial statements, they would be subject to audit by the registrant's independent public accountants, and they would fall within the scope of the registrant's internal control over financial reporting (ICFR).

Proposed Article 14 is closely related to proposed Subpart 1500 of Regulation S-K, which contains requirements for disclosures outside the financial statements. It cross-references Subpart 1500 and uses terms defined there. Like Subpart 1500, it uses concepts drawn from the TCFD (Task Force on Climate-Related Financial Disclosures) disclosure framework, notably the concepts of climate-related risks, which are potential negative effects (divided between physical risks and transition risks),[2] and climate-related opportunities, which are potential positive effects.[3] Generally the disclosures relating to opportunities are optional, but a registrant that chooses to disclose them must do so consistently across years, line items and opportunities.

B. Required Metrics

1. Four Types of Required Metrics

The proposed rules use the word "metrics" to refer to quantitative disclosures. They require disclosure of two kinds of metrics ("financial impact" metrics and expenditure metrics) for each of two categories (physical risks and transition risks), resulting in four types of information:

Financial impact metrics

- **Physical impacts** – Impact during the year of "severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise." (Rule 14-02(c).) The rule text provides examples of the kinds of physical impacts these events could have on financial statements. In addition to the enumerated items, the registrant must include the impact of physical risks it identifies in its required disclosures on "strategy, business model, and outlook" pursuant to proposed Item 1502(a) of Regulation S-K.

- **Transition impacts** – Impact during the year of transition activities, defined as "any efforts to reduce GHG emissions or otherwise mitigate exposure to transition risks." (Rule 14-02(d).) Here again, the rule

[1] The proposal is set forth in the SEC's March 21, 2022 release, available here.
[2] Climate related risks are defined in proposed Item 1500(c) as "the actual or potential negative impacts of climate-related conditions and events on a registrant's consolidated financial statements, business operations, or value chains, as a whole." The definition then proceeds to identify physical risks, acute risks and chronic risks.
[3] Climate-related opportunities are defined in proposed Item 1500(c) as "the actual or potential positive impacts of climate-related conditions and events on a registrant's consolidated financial statements, business operation, or value chains, as a whole."

text provides examples and requires inclusion of transition risks identified pursuant to proposed Item 1502(a) of Regulation S-K.

Expenditure metrics

- **Mitigation expenditures** – Expenditures during the year "to mitigate the risks from severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise." (Rule 14-02(e).) Expenditures include amounts that are recognized as expense in the current period and amounts that are capitalized during the current period.
- **Transition expenditures** – Expenditures during the year "to reduce GHG emissions or otherwise mitigate exposure to transition risks." (Rule 14-02(f).)

2. Financial Impact Metrics: Line-by-Line Basis; 1% Threshold

Each of the financial impact metrics must be presented "on an aggregated line-by-line basis for all negative impacts and, separately, at a minimum, on an aggregated line-by-line basis for all positive impacts." If the impact on a given line item is less than 1%, the impact may be omitted. (Rule 14-02(b)(1).) As explained (with illustrations) in the proposing release, this means that:

- Financial impacts must be determined for each line item of the financial statements. The examples in the proposing release refer to items in the income statement or the balance sheet, but the rule text would appear to capture the cash flow statement, too.
- For each line item, the financial impacts must be measured against a threshold equal to 1% of that line item. For this purpose, the registrant must use absolute values, not net values – *i.e.*, a credit of 1 and a debit of 1 means an impact of 2 (not zero). If the sum of the absolute values of all impacts is less than 1% of the line item, no disclosure is required.
- For each line item, positive impacts must be presented separately from negative impacts. However, positive impacts and negative impacts may each be aggregated.

3. Expenditure Metrics: Separation of Expensed and Capitalized Expenditures; 1% Threshold

The proposed rules' treatment of expenditure metrics requires separate analysis of amounts that are expensed in the current year and amounts that are capitalized. For each of the two metrics, the note must "[d]isclose separately the aggregate amount of expenditure expensed and the aggregate amount of capitalized costs incurred." However, no disclosure is required for expensed climate-related expenditures if they are less than 1% of total expensed expenditures; and similarly no disclosure is required for capitalized climate-related expenditures if they are less than 1% of total capitalized expenditures. (Rule 14-02(b)(2).)

4. Periods To Be Presented

Under the proposed rules, the financial metrics are required for all periods for which financial statements are presented – typically two years for the balance sheet and three years for the income statement, subject to the usual accommodation for emerging growth companies. The proposing release acknowledges that this information may be difficult to obtain for periods prior to the current period – a problem that will be particularly likely to arise when the proposed rules first take effect – and it notes that historical information that was not previously required to be presented might fall within two existing rules: Securities Act Rule 409 and Exchange Act Rule 12b-21. Both permit the omission of information that is not reasonably available without unreasonable effort or expense, although the threshold for reliance on them is generally thought to be high.

5. General Considerations Relating to Financial Metrics

The disclosure of financial metrics must be consistent with the general presentation of the financial statements. The financial metrics must use information for the same companies and applying the same set of accounting principles as are applied to the rest of the financial statements.

The registrant must also provide contextual information describing how each metric was derived, including specific inputs, assumptions and policy decisions.

B. Impacts on Financial Estimates and Assumptions

The proposed rules would require that the registrant provide qualitative information on how climate-related risks have affected the estimates and assumptions used to produce the financial statements. This disclosure is required as to both physical risks ("risks and uncertainties associated with, or known impacts from, severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise") and transition risks ("risks and uncertainties associated with, or known impacts from, a potential transition to a lower carbon economy or any climate-related targets disclosed by the registrant"). If the registrant identifies such impacts, it must provide disclosure on how the risks may affect the judgments made in preparation of the financial statements. The proposing release gives as examples such matters as impairment testing and commodity price assumptions.

C. Impact of Opportunities

The mandatory disclosures under the proposed rules relate to impacts of climate-related physical risk and transition risk, but the proposed rules would also permit disclosure about climate-related opportunities and their impact on the other required disclosures. (Rule 14-02(j).) If the registrant discloses the impact of an opportunity, it must do so consistently for all years, line items and opportunities.

II. Key Takeaways

- *Complexity*. The proposed Article 14 is complex, and it will be complex to apply. Much of the work to apply it could be subterranean, in the sense that it will not result in any disclosure because it identifies a large number of nil or negligible amounts. The resulting disclosures could also be complex, depending on the registrant.
- *New Concepts*. The proposed rules will require the development of new concepts and measurement techniques, for which two objectives of financial statement presentation – consistent application across issuers and an auditable level of precision – may be elusive.
- *Reporting Infrastructure*. As with much of the disclosure called for by the SEC's climate-related disclosure proposal, registrants will need to develop systems to analyze and classify the information

required under the proposed rules, and they will need to integrate those systems with existing financial reporting systems and ICFR.

- *Role of the auditor*. The SEC's decision to propose that this information be included in a note to the audited financial statements has important consequences. The auditors will need to be closely involved, and their standards and expectations (and those of their regulator, the PCAOB) will influence how registrants approach the requirements. The proposing release argues that this will enhance reliability. For registrants, it will also require additional coordination and sufficient mechanisms to ensure smooth implementation. For auditors, the expanded scope may present a challenge, given the novelty of the metrics, which could have both cost and timing implications for both the registrant and its auditors.
- *SEC Authority over Financial Statements*. Including this information in a note to financial statements brings it under the SEC's statutory authority to establish accounting standards, which is particularly clear. This may make proposed Article 14 especially resistant to legal challenges by opponents of the climate-related disclosure proposals.
- *Disaggregation*. The proposing release argues that the requirement of disaggregation is not novel for financial statement disclosure and is seen in other contexts, such as segment reporting. However, here disaggregation is used in several intersecting ways: disaggregation of the climate-risk metrics from the rest of the financial statements, disaggregation of positive and negative impacts, and disaggregation of the disclosure for the different types of risks. (One question raised in the proposing release is whether the climate-related disclosures should be further disaggregated by segment.) The proposing release contends that such separation allows for clearer and more comparable disclosure that allows investors to more easily identify the negative and positive impacts of climate change on the company.
- *1% Threshold*. The disclosure requirements for financial metrics will be subject to a 1% threshold (measured differently for financial impact metrics and for expenditure metrics). The proposing release argues that this "bright-line standard" will promote comparability and consistency over time and among registrants and reduce the risk of underreporting. However, 1% is a particularly low threshold, which will augment the implementation challenges and potentially the complexity of disclosure.
- *Transition*. The proposed rules would require the climate-related note to provide information for all periods presented in the audited financial statements. This is likely to prove challenging in the first two years of the new rules' effectiveness. It could also prove difficult in other situations – for example, consolidating a newly-acquired company for the first time or becoming subject to the reporting requirements in an IPO. The proposing release points to existing rules that might address this challenge, but whether those rules will successfully protect against unduly burdensome disclosure will depend on the future practices of the SEC staff and the auditing firms.

This is one in a series of memos we will be publishing about the proposed amendments. We will also be publishing a series of articles diving deeper into selected issues under the proposal.

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Cleary's New York Sustainability Working Group

If you have any questions about the SEC's new proposed rules on climate-related disclosures or about any other climate, sustainability or ESG-related questions, please feel free to contact your regular contacts at the firm or any of the Sustainability Working Group members below.

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Annex 1 : Proposed New Article 14 of Regulation S-X

[Rule 14-01] Climate-related disclosure instructions.

(a) *General*. A registrant must include disclosure pursuant to [Rule 14-02] in any filing that is required to include disclosure pursuant to [Part 1500 of Regulation S-K] and that also requires the registrant to include its audited financial statements. The disclosure pursuant to [Rule 14-02] must be included in a note to the financial statements included in such filing.

(b) *Definitions*. The definitions in [Item 1500 of Regulation S-K] apply to this Article 14 of Regulation S-X.

(c) *Basis of calculation*. When calculating the metrics in this Article 14, except where otherwise indicated, a registrant must:

(1) Use financial information that is consistent with the scope of the rest of its consolidated financial statements included in the filing; and

(2) Whenever applicable, apply the same accounting principles that it is required to apply in preparation of the rest of its consolidated financial statements included in the filing.

(d) *Historical periods*. Disclosure must be provided for the registrant's most recently completed fiscal year, and for the historical fiscal year(s) included in the consolidated financial statements in the filing (e.g., a registrant that is required to include balance sheets as of the end of its two most recent fiscal years and income statements and cash flow statements as of the end of its three most recent fiscal years would be required to disclose two years of the climate-related metrics that correspond to balance sheet line items and three years of the climate-related metrics that correspond to income statement or cash flow statement line items).

[Rule 14-02] Climate-related metrics.

(a) *Contextual information*. Provide contextual information, describing how each specified metric was derived, including a description of significant inputs and assumptions used, and, if applicable, policy decisions made by the registrant to calculate the specified metrics.

(b) *Disclosure thresholds*.

(1) Disclosure of the financial impact on a line item in the registrant's consolidated financial statements pursuant to paragraphs (c) and (d) of this section (including any impacts included pursuant to paragraphs (i) and (j) of this section) is not required if the sum of the absolute values of all the impacts on the line item is less than one percent of the total line item for the relevant fiscal year.

(2) Disclosure of the aggregate amount of expenditure expensed or the aggregate amount of capitalized costs incurred pursuant to paragraphs (e) and (f) of this section (including any impacts included pursuant to paragraphs (i) and (j) of this section) is not required if such amount is less than one percent of the total expenditure expensed or total capitalized costs incurred, respectively, for the relevant fiscal year.

(c) *Financial impacts of severe weather events and other natural conditions*. Disclose the impact of severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise on any relevant line items in the registrant's consolidated financial statements during the fiscal years presented. Disclosure must be presented, at a minimum, on an aggregated line-by-line basis for all negative impacts and, separately, at a minimum, on an aggregated line-by-line basis for all positive impacts. Impacts may include, for example:

(1) Changes to revenues or costs from disruptions to business operations or supply chains;

(2) Impairment charges and changes to the carrying amount of assets (such as inventory, intangibles, and property, plant and equipment) due to the assets being exposed to severe weather, flooding, drought, wildfires, extreme temperatures, and sea level rise;

(3) Changes to loss contingencies or reserves (such as environmental reserves or loan loss allowances) due to impact from severe weather events; and

(4) Changes to total expected insured losses due to flooding or wildfire patterns.

(d) *Financial impacts related to transition activities*. Disclose the impact of any efforts to reduce GHG emissions or otherwise mitigate exposure to transition risks on any relevant line items in the registrant's consolidated financial statements during the fiscal years presented. Disclosure must be presented, at a minimum, on an aggregated line-by-line basis for all negative impacts and, separately, at a minimum, on an aggregated line-by-line basis for all positive impacts. Impacts may include, for example:

(1) Changes to revenue or cost due to new emissions pricing or regulations resulting in the loss of a sales contract;
(2) Changes to operating, investing, or financing cash flow from changes in upstream costs, such as transportation of raw materials;
(3) Changes to the carrying amount of assets (such as intangibles and property, plant, and equipment) due to, among other things, a reduction of the asset's useful life or a change in the asset's salvage value by being exposed to transition activities; and
(4) Changes to interest expense driven by financing instruments such as climate-linked bonds issued where the interest rate increases if certain climate-related targets are not met.

(e) *Expenditure to mitigate risks of severe weather events and other natural conditions*. Disclose separately the aggregate amount of expenditure expensed and the aggregate amount of capitalized costs incurred during the fiscal years presented to mitigate the risks from severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise. For example, a registrant may be required to disclose the amount of expense or capitalized costs, as applicable, to increase the resilience of assets or operations, retire or shorten the estimated useful lives of impacted assets, relocate assets or operations at risk, or otherwise reduce the future impact of severe weather events and other natural conditions on business operations.

(f) *Expenditure related to transition activities*. Disclose separately the aggregate amount of expenditure expensed and the aggregate amount of capitalized costs incurred during the fiscal years presented to reduce GHG emissions or otherwise mitigate exposure to transition risks. For example, a registrant may be required to disclose the amount of expense or capitalized costs, as applicable, related to research and development of new technologies, purchase of assets, infrastructure, or products that are intended to reduce GHG emissions, increase energy efficiency, offset emissions (purchase of energy credits), or improve other resource efficiency. A registrant that has disclosed GHG emissions reduction targets or other climate-related commitments must disclose the expenditures and costs related to meeting its targets, commitments, and goals, if any, in the fiscal years presented.

(g) *Financial estimates and assumptions impacted by severe weather events and other natural conditions*. Disclose whether the estimates and assumptions the registrant used to produce the consolidated financial statements were impacted by exposures to risks and uncertainties associated with, or known impacts from, severe weather events and other natural conditions, such as flooding, drought, wildfires, extreme temperatures, and sea level rise. If yes, provide a qualitative description of how the development of such estimates and assumptions were impacted by such events.

(h) *Financial estimates and assumptions impacted by transition activities*. Disclose whether the estimates and assumptions the registrant used to produce the consolidated financial statements were impacted by risks and uncertainties associated with, or known impacts from, a potential transition to a lower carbon economy or any climate-related targets disclosed by the registrant. If yes, provide a qualitative description of how the development of such estimates and assumptions were impacted by such a potential transition or the registrant's disclosed climate-related targets.

(i) *Impact of identified climate-related risks*. A registrant must also include the impact of any climate-related risks (separately by physical risks and transition risks, as defined in [Item 1500(c) of Regulation S-K], identified by the registrant pursuant to [Item 1502(a) of Regulation S-K], on any of the financial statement metrics disclosed pursuant to paragraphs (c) through (h) of this section.

(j) *Impact of climate-related opportunities*. A registrant may also include the impact of any opportunities arising from severe weather events and other natural conditions, any impact of efforts to pursue climate-related opportunities associated with transition activities, and the impact of any other climate-related opportunities, including those identified by the registrant pursuant to [Item 1502(a) of Regulation S-K], on any of the financial statement metrics disclosed pursuant to paragraphs (c) through (h) of this section. If a registrant makes a policy decision to disclose the impact of an opportunity, it must do so consistently for the fiscal years presented, including for each financial statement line item and all relevant opportunities identified by the registrant.