June 17, 2022

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
VIA EMAIL

Re: The Enhancement and Standardization of Climate-Related Disclosures for Investors (File No. S7-10-22)

Dear Ms. Countryman:

As professors of accounting and finance and former Chief Economists of the Securities and Exchange Commission (SEC or Commission), we write to provide our perspective on the Commission's recent proposal entitled "The Enhancement and Standardization of Climate-Related Disclosures" (the Proposal). Beyond requiring climate-related disclosures in the narrative portion of the financial statements, the Proposal would require several quantitative metrics to be incorporated in the notes to the financial statements.[1] In our view, the Proposal's stark departure from the established accounting standard-setting process and precedents would compromise the integrity of the financial statements that investors rely on to make important investment decisions. In addition, the Proposal would impose significant costs on both registrants and the broader economy, a fact the Proposal does not adequately address.

I. The Proposal Subverts the Independent Accounting Standard-Setting Process

For decades, our financial accounting system has been built on a joint responsibility system whereby an independent, expert, private-sector body produces accounting standards under the oversight of the SEC. This structure was deliberately chosen after careful consideration, and for good reason. While the SEC has authority to promulgate accounting standards,[2] private sector standard-setting bodies have historically taken on this responsibility – first with the Committee on Accounting Procedure established in 1939, then with the Accounting Principles Board established in 1959, and finally with the Financial Accounting Standards Board (FASB) established in 1972. The FASB was formed following a recommendation from the Wheat Committee, which conducted a thorough review of accounting standard-setting at the request of the American Institute of Certified Public Accountants. The Wheat Committee specifically examined the question of whether accounting standards should be set by a private sector body or the government, and concluded that they should be set by the private sector to protect from political pressures and guard against serving the interests of special interest groups instead of investors.[3] The Commission

[1] 87 Fed. Reg 21334, 21363 – 21364.
[2] *See* section 19(a) of the Securities Act of 1933 and section 13(b)(1) of the Securities Exchange Act of 1934.
[3] *See* American Institute of Certified Public Accountants, *Study on Establishment of Accounting Principles* (Mar. 29, 1972) at 22 ("Government agencies may be more susceptible to political pressures than private bodies")

endorsed the establishment of the FASB and announced it would consider FASB's standards as having substantial authoritative support,[4] a position the SEC holds to this day.[5]

The FASB's structure was designed to counteract the pressures from political and special interests that the Wheat Committee found concerning. FASB Board members serve full-time, are appointed by Financial Accounting Foundation trustees to five-year terms, and come from a variety of backgrounds related to the financial reporting field. Funding for the FASB is provided from the private sector, not the government, and is made up primarily of accounting support fees paid by public companies.[6] SEC oversight of the FASB is a critical part of the FASB's structure.[7] Interaction between the FASB and the SEC includes the SEC recommending items for the technical agenda. The fact that the SEC has the ultimate authority to promulgate accounting standards and can reserve this role for itself at any time ensures a continued productive relationship between the two entities.

Under the current standard setting process, the FASB is held to a strict protocol to ensure only the highest quality standards are adopted. The Rules of Procedure set out a deliberative standard setting process that is designed to seek the input of *all* stakeholders, including through public roundtables and Board deliberation at public meetings.[8] A cost-benefit analysis is integrated throughout the standard-setting process.[9]

Rather than acting pursuant to the system that has worked well for decades, the Proposal seeks to subvert the FASB's authority over accounting standards. By requiring companies to disclose climate-related financial metrics in the notes to the financial statements,[10] the Proposal disregards the FASB's remit and seeks to undertake the task of setting accounting standards for itself.[11] The removal of accounting standard-setting from an expert, independent process threatens the integrity of the financial statements and their continued usefulness to those who need them to make investment decisions. In fact, many of the concerns the Wheat Committee expressed regarding government accounting standard-setting – political pressures and standards that are designed to meet the objectives of private interest groups – are implicated by the Proposal. Furthermore, the accounting standards set by the Proposal will not benefit from the extensive due process prescribed by the FASB or the expertise that Board members bring to the process.

("[Government standard setting] could lead to accounting standards being designed to accomplish self-serving objectives of private interest groups rather than solely to meet the needs of those who use financial statements in making economic decisions").

[4] *See* SEC, Accounting Standards Release No. 150 (Dec. 20, 1973).

[5] *See* Paul Munter, Acting Chief Accountant, SEC, *Statement on the FASB's Agenda Consultation: Engagement with Investors and Other Stakeholders Vital to Development of High Quality Accounting Standards* (Feb. 22, 2022) ("The Commission has long recognized the importance of FASB's role as an independent accounting standard setter").

[6] *See* section 109 of the Sarbanes-Oxley Act of 2002.

[7] *See, e.g.,* Robert K. Herdman, Chief Accountant, SEC, *Testimony Concerning the Roles of the SEC and the FASB in Establishing GAAP* (May 14, 2002).

[8] FASB, *Rules of Procedure* (amended and restated through Aug. 10, 2021).

[9] *See* FASB, *Cost-Benefit Analysis* (last visited June 13, 2022), https://www.fasb.org/Page/PageContent?PageId=/about-us/standardsettingprocess/cba.html&bcpath=tff.

[10] *See* 87 Fed. Reg. at 21363 – 2164.

[11] *See, e.g.,* Nicola M. White, *Climate Plan Puts SEC in Rare Role as Accounting Rule-Writer,* Bloomberg Tax (Mar. 23, 2022), https://news.bloombergtax.com/financial-accounting/climate-plan-puts-sec-in-rare-role-as-accounting-rule-writer.

II. The Proposal Mandates Disclosures in the Notes to the Financial Statements That Are Inconsistent with Existing Accounting Standards

Not only are the disclosures required by the Proposal promulgated outside of the proper process, but they are inconsistent with current accounting standards in several respects. Even the Proposal acknowledges this shortcoming.[12] There are multiple FASB standards that already require consideration of material items related to the climate. For example, companies are required to disclose as a loss contingency environmental obligations that may arise from regulatory, legal, and contractual requirements.[13] The value of property, plant and equipment must be tested for impairment, which can result from environmental factors.[14] Similarly, the value of intangible assets may be impacted by environmental factors that affect the highest and best use of an asset.[15] Given these existing rules, there would be little to no value to investors from any additional disclosure about climate-related impacts in the financial statements.

Perhaps of most concern, the disclosures in the Proposal are a drastic departure from the materiality standard that is at the heart of the financial statements. While materiality is based on individual facts and circumstances and there are no set quantitative thresholds, the accounting profession has recognized a 5% threshold as a rule of thumb, and the SEC staff has endorsed this position as a starting point.[16] In the Proposal, a climate impact is considered material and must be disclosed if it exceeds 1% of the corresponding financial statement *line item*.[17] This 1% threshold is significantly less than the 5% threshold that the SEC staff has previously endorsed. In every other area of the financial statements, materiality is based on the impact a particular matter has on the financial statements as a whole.[18] Here, however, the SEC requires materiality to be assessed based on the climate impact of each line item of the financial statements, which will result in significantly more disclosures.[19] Moreover, the Proposal further dilutes the meaning of materiality by not allowing positive and negative impacts to be netted against each other, as is routine when assessing materiality.[20] Rather, the Proposal would require filers to tabulate the absolute value of the impacts in order to make a materiality assessment.[21]

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[12] *See* 87 Fed. Reg. at 21364 (referring to the "possible confusion that may arise between the current body of GAAP and the proposed requirements").
[13] *See* ASC Subtopic 410-30, Asset Retirement and Environmental Obligations.
[14] *See* ASC Topic 360, Property, Plant, and Equipment.
[15] *See* ASC Topic 820, Fair Value Measurement.
[16] *See* SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999).
[17] 87 Fed. Reg. at 21366.
[18] *See* SEC, Staff Accounting Bulletin No. 99 (Aug. 12, 1999) (citing example where combined misstatements result in a 4% overstatement of net income and 4% overstatement of earnings per share); James Brady Vorhies, *The New Importance of Materiality*, Journal of Accountancy (May 1, 2005), https://www.journalofaccountancy.com/issues/2005/may/thenewimportanceofmateriality.html ("Working materiality levels or quantitative estimates of materiality generally are based on the 5% rule, which holds that reasonable investors would not be influenced in their investment decisions by a fluctuation in net income of 5% or less").
[19] 87 Fed. Reg. at 21366.
[20] *See* James Brady Vorhies, *supra* note 18 ("Nor would the investor be swayed by a fluctuation or a series of fluctuation of less than 5% in income statement line items, as long as the net change was less than 5%").
[21] 87 Fed. Reg. at 21366.

The Supreme Court has ruled that in order for information to be material, there must be a substantial likelihood that a reasonable shareholder *would* consider it important in deciding how to vote, buy or sell a security.[22] The FASB's definition of materiality for purposes of accounting standards mirrors this definition.[23] In adopting this definition, the FASB rejected the more expansive definition of materiality recognized by the International Accounting Standards Board (IASB), which considers whether information *could* reasonably be expected to influence decisions by financial statement users.[24] The materiality standard set in the Proposal for the notes to the financial statements dispenses with the longstanding definition of materiality recognized in the U.S. and moves towards the IASB's definition of materiality. The FASB has also recognized that materiality standards should not be strictly prescribed, but discretion should be allowed for the judgments of those who best understand the company:

> No general standards of materiality could be formulated to take into account all the considerations that enter into judgments made by an experienced, reasonable provider of financial information. That is because materiality judgments can properly be made only by those that understand the reporting entity's pertinent facts and circumstances. **Whenever an authoritative body imposes materiality rules or standards, it is substituting generalized collective judgments for specific individual judgments, and there is no reason to suppose that the collective judgments always are superior**.[25]

By setting a specific materiality threshold in the Proposal, the SEC is carrying out precisely what the FASB warned against by substituting its generalized collective judgement for the specific individual judgments of professionals who are best suited to provide a company-specific analysis.

In sum, it is evident that the materiality requirements for the notes to the financial statements were designed to require companies to report the largest amount of climate information possible, without regard to whether that information would be considered relevant by investors. While this may accomplish the SEC and certain stakeholders' goals of bringing more attention to climate matters,[26] it does nothing to help investors understand the information that is important to the company and how such information drives future growth. To the contrary, it will almost

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[22] *See TSC Industries, Inc v. Northway, Inc.,* 426 U.S. 438 (1976).

[23] *See* FASB, Statement of Financial Accounting Concepts No. 8, Chapter 3, para. QC11 (as amended in Aug. 2018) ("The omission or misstatement of an item in a financial report is material if, in light of the surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item").

[24] *See* IASB, Conceptual Framework for Financial Reporting, para. 2.11 (as amended in March 2018) (emphasis added).

[25] *See* FASB, Statement of Financial Accounting Concepts No. 8, Chapter 3, para. QC11B (as amended in Aug. 2018) (emphasis added).

[26] *See, e.g.,* Climate Action 100+, *The Three* Asks (last visited June 16, 2022), https://www.climateaction100.org/approach/the-three-asks/ (Coalition of asset managers and institutional investors pushing companies to "provide enhanced corporate disclosure… to enable investors to assess the robustness of companies' business plans against a wide range of climate scenarios"); Larry Fink, Blackrock, *2021 Letter to CEOs*, https://www.blackrock.com/us/individual/2021-larry-fink-ceo-letter ("We are asking companies to disclose a plan for how their business model will be compatible with a net zero economy… we are asking you to disclose how this plan is incorporated into your long-term strategy and reviewed by your board of directors").

certainly "bury [investors] in an avalanche of trivial information,"[27] a result that the Supreme Court has opined "is hardly conducive to informed decision-making."[28]

Finally, the Proposal requires an explanation of the inputs, assumptions, and policy decisions for each financial statement footnote disclosure.[29] This is not a requirement for other impacts that are calculated based on Generally Accepted Accounting Principles (GAAP), and it demonstrates the amorphous nature of the climate impact disclosures. With this requirement, the SEC is admitting that climate impact disclosures are useless if not accompanied by explanations of how the impact was calculated. Rather than promoting uniform disclosures that are comparable across companies, the SEC would impose a requirement that will have no value to investors unless they read, understand, and compare companies' explanations of how their climate impact figures were derived. Even then, the metrics still would not be consistent and comparable across registrants and would provide little, if any, useful information to investors.

III. The Disclosures Required by the Proposal Are Not the Type of Information That Should Be Included in Financial Statements

Line-item climate-related impacts are not the type of information that should be mandated reporting for all entities in the financial statements. FASB's guidance on the notes to financial statements makes this clear.[30] This guidance states that information should only be required that is relevant to existing and potential users of the financial statements of a broad range of entities. In the case of climate disclosures, this information is of little value to investors in many industries. The guidance also warns that the benefits of providing the information should justify the costs of providing and consuming it, which the SEC has failed to demonstrate.[31] Finally, the guidance advises the Board to consider potential unintended adverse consequences of the disclosure, including the use of financial statements for purposes other than making resource allocation decisions that may negatively affect the company's ability to operate in its economic, legal, political, and social environments. The risk that climate data will be used for purposes other than resource allocation and will negatively impact a company's ability to operate in these environments is certainly present here.

Climate-related disclosures are not the appropriate type of information to include in the financial statements because they do not further the purpose of financial reporting. As the FASB states, "The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors making decisions about providing resources to the entity."[32] The FASB further makes clear that "Other parties, such as regulators and members of the public other than investors, lenders, and other creditors, also may find general financial reports useful. However, those reports are not

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[27] *See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 448-49 (1976). *See also* Business and Financial Disclosure Required by Regulation S-K, 81 Fed. Reg. 23916, 23919 (Apr. 22, 2016) ("There is also a possibility that high levels of immaterial disclosure can obscure important information or reduce incentives for certain market participants to trade or create markets for securities").
[28] *Id.*
[29] 87 Fed. Reg. at 21363.
[30] *See* FASB, Statement of Financial Accounting Concepts No. 8, Chapter 8, para. D22 (as amended in Dec. 2021).
[31] *See infra* Section IV.
[32] FASB, Statement of Financial Accounting Concepts No. 8, Chapter 1, para. OB2 (as amended in Dec. 2021).

primarily directed to those other groups."[33] Mandating financial statement line-item disclosures for all entities, regardless of materiality, is a requirement that primarily furthers the interests of these other groups. To the extent that climate-related information is relevant to resource allocation, it is already required to be disclosed under the SEC's current rules.[34] The requirement that climate-related information be disclosed in the financial statement notes came as a surprise to the industry,[35] suggesting that it was not seen as necessary to meet the needs of investors.

The disclosures also are inconsistent with the core principle that accounting standards should be neutral and not favor certain behavior over others. As the FASB explains, "Accounting standards are intended to neutrally reflect economic activity so that users of financial statements can make resource allocation decisions."[36] In a paper specific to ESG issues, the FASB further elaborates, "Financial accounting standards are not intended to drive behavior in any way, including benefitting one industry or business model over another or spurring businesses to take certain actions."[37] By elevating the status of climate-related impacts over other impacts that are subject to a stricter materiality threshold, the SEC is prioritizing climate-related risks over other risks, which will influence companies' behaviors and benefit certain industries over others.

The Proposal's disclosure requirements for the notes to financial statements fall short of the FASB's standards for useful financial information, specifically with regard to comparability and verifiability.[38] Climate modeling is an inherently complex and difficult endeavor,[39] and there are no accounting standards for the required climate-related disclosures that set clear guidelines for how they should be calculated. Physical risk requires selecting a climate model that predicts what the climate impact will be at various physical locations, which will result in a wide variety of outcomes depending on the model chosen. Transition risk is arguably even more subjective, as companies are forced to make predictions on how markets, technology, and the law will change; and how those changes will impact their business. Moreover, many of the disclosures attempt to forecast the potential climate impact over several years or even decades, which is nearly impossible to discern in a reliable manner. These forward-looking disclosures are also subject to technological innovation and adaptation that may take place in the future, which are currently unknown. The result is that the disclosures will not be comparable from company to company, will not be verifiable by independent observers, and will thus be of little value to investors seeking to make financial decisions. Even the companies themselves lack the tools to verify these estimates and will undoubtedly have to rely on outside experts to produce them.

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[33] FASB, Statement of Financial Accounting Concepts No. 8, Chapter 1, para. OB10 (as amended in Dec. 2021).

[34] *See* SEC, Commission Guidance Regarding Disclosure Related to Climate Change (Feb. 8, 2010), https://www.sec.gov/rules/interp/2010/33-9106.pdf.

[35] *See* Nicola M. White, *Climate Plan Puts SEC in Rare Role as Accounting Rule-Writer,* Bloomberg Tax (Mar. 23, 2022), https://news.bloombergtax.com/financial-accounting/climate-plan-puts-sec-in-rare-role-as-accounting-rule-writer (quoting the head of financial reporting advocacy at the Chartered Financial Analysts Institute as stating, "It's remarkable how much they've integrated it into the financial statement. I wasn't expecting it").

[36] FASB, Statement of Financial Accounting Concepts No. 8, Chapter 8, para. D29 (as amended in Dec. 2021).

[37] FASB*, Intersection of Environmental, Social, and Governance Matters with Financial Accounting Standards* (Mar. 2021) at 3.

[38] *See* FASB, Statement of Financial Accounting Concepts No. 8, Chapter 3, para. QC19 (as amended in August 2018).

[39] *See* Basal Committee on Banking Supervision, *Climate-Related Financial Risks – Measurement Methodologies* (Apr. 2021) at 17, https://www.bis.org/bcbs/publ/d518.pdf ("Climate risk measurement [is] complex and its outputs [are] less reliable as risk estimators").

There are serious implications to seeking to incorporate this type of subjective and judgment-based information into the financial statements. The notes to the financial statements are included in the certification by the CEO and CFO that the report does not contain any material misstatements or omissions and fairly represents the company's financial condition. Management is also required to sign off on the internal controls that led to the figures presented in the financial statements. Additionally, the auditor provides an opinion on whether the financial statements are fairly stated and comply in all material respects with GAAP. Thus, company management and the company's auditor could both be held liable for purportedly getting these disclosures wrong, even though there is no consensus for how they should be calculated and very few tools available for doing so. It not even clear what standard the SEC would hold companies and auditors to for purposes of enforcement, given the inherently subjective nature of the disclosures.

IV. The Commission Has Not Conducted an Adequate Cost Benefit Analysis of the Proposal

Financial accounting issues notwithstanding, as former SEC chief economists we would be remiss not to discuss a glaring weakness of the Proposal - the failure to conduct an adequate cost-benefit analysis. The sheer scope and breadth of the Proposal warrant an extensive cost-benefit analysis. The Commission owes the public ample assurances that the benefits of the overhaul to the securities disclosure regime it is proposing outweigh its costs.

By the Commission's own estimates, the Proposal would more than double the total cost and the amount of employee time required to comply with the disclosure requirements for the set of ten major Commission reports the Proposal would affect.[40] As is usually the case, the true costs are likely to run much higher than the Commission's estimates. Yet, the Commission does not even attempt to assess the benefits of the Proposal qualitatively, much less quantitatively. Rather, throughout the release, the Commission merely asserts that its proposed disclosures "could" or "may" be of value to investors.

Moreover, the larger economic costs of the Proposal run well beyond the costs to registrants of providing the information required in the reports. Indeed, the Commission does not attempt to understand the effect of the changes across the economy it acknowledges the rule would produce, much less engage in a cost-benefit analysis.[41] For example, the Commission states that "a firm may choose to change some suppliers or disengage with certain clients due to the effect that they may have on the firm's Scope 3 emissions."[42] Yet, the Commission fails to quantify these costs or even discuss what the impact might be, particularly on small businesses and their employees with whom registrants cease to do business.

V. Conclusion

In sum, the climate-related disclosures that the Proposal introduces would significantly diminish the usefulness of financial statements to investors and to the integrity of the accounting standard-setting process. The Proposal ignores the role of the FASB as an independent accounting standard-setter and contradicts existing precedent for the content of the financial statements. The

[40] 87 Fed. Reg. at 21461.
[41] 87 Fed. Reg. at 21447-48.
[42] 87 Fed. Reg. at 21448.

required disclosures do not meet the standards for the type of information that should be included in the financial statements and would ultimately expose companies to serious legal risks and investors to receiving a distorted picture of the financial position of the company. Finally, the Commission does not adequately consider the significant costs this Proposal is likely to bear on the economy given the burden it places on companies both public and private.

Sincerely,

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