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VIEWPOINT

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ESG DISCLOSURE: MANDATORY INCLUSION OF SCOPE 3 EMISSIONS WILL HURT SMALL BUSINESSES

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There has been growing pressure of late to include environmental, social, and governance (ESG) information in reporting and public disclosure.[1] This is due both to interest from investors[2] and to a focus on new sustainability requirements from governments and regulators.[3]

Currently, there are no Canadian regulations requiring businesses to publicly disclose ESG information or sustainability reports, but this could soon change.[4] Indeed, establishing disclosure standards on sustainability and climate change is a federal policy priority. To meet its net-zero goals, the federal government has clearly stated its commitment to pushing ahead with mandatory reporting of climate-related financial risks across a wide range of the Canadian economy.[5]

The Canadian Securities Administrators coordinate and harmonize regulation for Canadian capital markets[6] and are working to establish requirements for publicly traded companies to make climate-related disclosures.[7] In fact, a new Canadian Sustainability Standards Board (CSSB) is set to launch in 2023 and has been tasked to work with the International Sustainability Standards Board (ISSB) to ensure that sustainability disclosures are standardized.[8]

The ISSB's goal is to "deliver a comprehensive global baseline of sustainability-related disclosure standards that provide investors and other capital market participants with information about companies' sustainability-related risks and opportunities."[9] Accordingly, it has proposed a set of IFRS Sustainability Disclosure Standards[10] to regulate ESG reporting. These are what the CSSB will be adopting.[11]

THE PROBLEM WITH SCOPE 3 EMISSIONS

In a 120-day public consultation, draft IFRS Standards received feedback from more than 700 respondents,[12] including more than 80 Canadian organizations.[13] Yet while the IFRS Standards have clear support according to the ISSB, there are a number of topics that deserve further deliberation.[14] One of these is the inclusion of Scope 3 greenhouse gas (GHG) emissions and the practical challenges of collecting and calculating that data.

Scope 3 emissions are often a company's largest source of emissions.[15] Also called "value-chain emissions," these arise from activities or assets not owned or controlled by the reporting organization.[16] They are "the fatal flaw in GHG reporting,"[17] since the Scope 3 emissions

Table 1

An upstream and downstream view of Scope 1, 2, and 3 emissions

Scope 2 Indirect emissions	Scope 3 Indirect emissions		Scope 1 Direct emissions	Scope 3 Indirect emissions	
Purchased electricity, steam, heating & cooling for own use	Purchased goods and services	Waste generated in operations	Company facilities	Transportation, distribution	Leased assets
	Capital goods	Business travel	Company vehicles	Processing of sold products	Franchises
	Fuel and energy related activities	Employee commuting		Use of sold products	Investments
	Transportation and distribution	Leased assets		End-of-life treatment of sold products	
Upstream activities →			Reporting company →	Downstream activities →	

Source: Aron Vallinder, "Scope 1, 2, and 3 emissions explained," *Normative*, January 13, 2022.

of one company are the Scope 1 and 2 emissions of another organization (see Table 1).

Scope 3 emissions are notoriously difficult to quantify, and the requirement for an entity to monitor and report on every interaction and relationship along the value chain, between multiple suppliers and customers, introduces a real risk of measurement error.[18] The inclusion of Scope 3 emissions in GHG reporting also presents a risk of duplication in accounting such that emissions are counted several times over, which does not provide an accurate representation of climate risk.[19]

CREATING ARTIFICIAL WINNERS AND LOSERS

Moreover, the inclusion of Scope 3 GHG emissions in reporting represents an onerous burden. Many entities lack sufficient resources to be able to fully comply,[20] especially small and medium-sized enterprises (SMEs).[21] The U.S. Securities and Exchange Commission estimates that a similar disclosure proposal in the United States costs between US$490,000 and US$640,000 on average for the first year of compliance—although some believe that "actual costs may be substantially higher."[22]

In addition, although the proposed standards would apply to publicly listed companies, there are implications for smaller, private companies as well. For instance, an SME that supplies products to a larger, public company is part of the latter's value chain and can expect disclosure demands as part of the larger Scope 3 disclosure. It follows that companies required to disclose will choose suppliers able to help them meet their obligations. This requirement is therefore likely to create an obstacle for private companies not large enough to have a compliance department.[23]

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SMEs are significant contributors to the Canadian economy, but they have been weathering a particularly difficult storm for the past few years. In 2021, small businesses were more likely to have lower revenues than in 2019, and in the first quarter of 2022 were found to be more likely to have decreased sales in the short term.[24] Increased costs to remain a part of the supply chains of public companies are the

opposite of what SMEs need to remain viable as Canada teeters on the verge of recession.

Increased costs to remain a part of the supply chains of public companies are the opposite of what SMEs need.

In addition to the proposed requirement's potential for error and its outsized impact on Canadian SMEs, it should be noted that companies which can afford higher compliance costs will inevitably pass these along to consumers. The federal government should be critical of a policy that will be overly burdensome and artificially create winners and losers, while ultimately increasing the cost of living for Canadians. As such, the mandatory reporting of Scope 3 emissions should not be included in ESG disclosure requirements.

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