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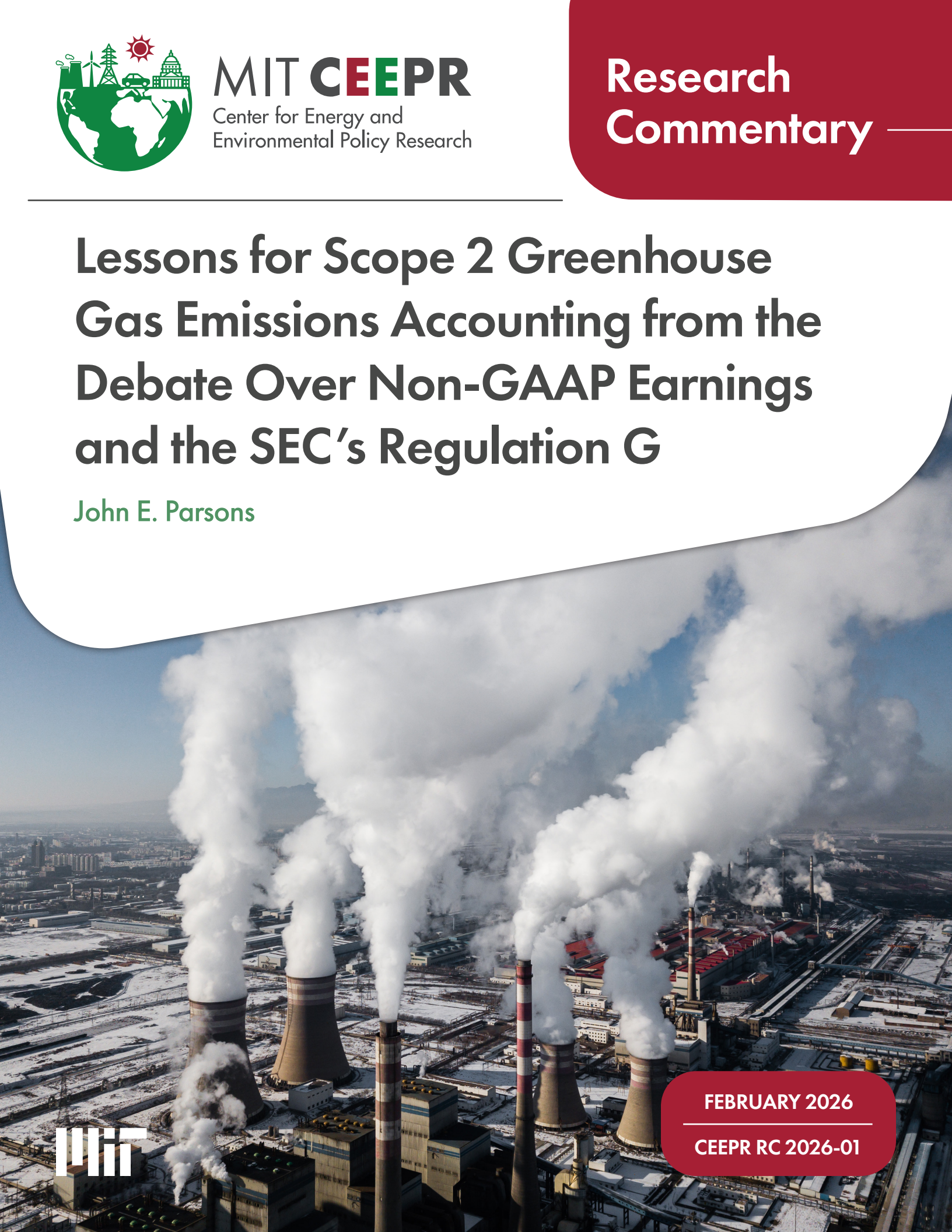

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Lessons for Scope 2 Greenhouse Gas Emissions Accounting from the Debate Over Non-GAAP Earnings and the SEC's Regulation G

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1 Introduction

Many companies report their Greenhouse Gas (GHG) emissions in accordance with the accounting criteria laid out in the Greenhouse Gas Protocol's (the Protocol) Corporate Standard. For a number of years, a debate has been brewing concerning the best way to report on the indirect emissions from the generation of purchased electricity, which falls into the Protocol's Scope 2 category.[1] Currently, the Protocol includes two metrics. One is location-based, in which the reported emissions reflect the average emissions intensity of the electric grid where the electricity is consumed. Another is market-based, in which the reported emissions reflect the emissions intensity of the generation contracted to supply the company's consumption. Both metrics attempt to inventory emissions directly attributable to the company's electric load, subject to the constraints of available data. A competing alternative, known as 'consequential' or 'impact accounting', looks beyond the boundary of the company's own operations, and attempts to include the impact of its actions on the larger system's emissions. For example, in 2023 the company Salesforce committed to purchasing electricity from small distributed clean energy projects across sub-Saharan Africa, Latin America and Southeast Asia, far from the location of its own operations. They say this action would make a significant reduction in emissions in those regions, but under the current rules of the Protocol this action does not reduce the company's reported Scope 2 emissions.[2] The alternative, consequential accounting would have Salesforce's action reduce its reported Scope 2 emissions. The debate has heated up since there is currently an ongoing stakeholder process to update the Protocol, including potential changes to the Scope 2 inventory accounting.

This note contributes to the debate by means of a review of the history of an analogous debate in corporate financial accounting standards. These standards, whether US Generally Accepted Accounting Principles (GAAP) or the International Accounting Standards Board's International Financial Reporting Standards (IFRS), specify methodologies for calculating corporate earnings. In the 1990s and early 2000s, there was a steady increase in the number of companies reporting and highlighting alternative, non-GAAP measures of earnings alongside the mandated GAAP earnings. The non-GAAP earnings were usually higher

[1]The Protocol sorts a company's emissions into three categories. Scope 1 encompasses direct GHG emissions from sources that are owned and controlled by the company. Scope 2 accounts for GHG emissions from the generation of purchased electricity. Scope 3 includes all other indirect emissions.

[2]The example is provided on the website of the Emissions First Partnership, emmissionsfirst.com/what-is-impact-accounting.

than GAAP earnings because they added back to GAAP earnings certain expenses that companies insisted were non-recurring or otherwise outside the ordinary course of business. Management would describe their alternative as 'core earnings', or similar nomenclature, to suggest it as a better measure of the company's performance. On the other side, this practice was derided by some at the time as "a marked increase of corporate number games." Then, following upon a number of large corporate accounting scandals, including Enron and Worldcom, among others, the US Congress passed the Sarbanes-Oxley Act of 2002, which mandated many reforms, including direction to the US Securities and Exchange Commission (SEC) to establish rules regulating the release of non-GAAP earnings, which the SEC did with its issuance of Regulation G and subsequent actions. Regulation G imposed additional disclosure and filing requirements on companies that chose to report non-GAAP earnings, requiring, among other things, reconciliation of the non-GAAP measures to the nearest GAAP measure. In the succeeding decades there have been a number of modifications to Regulation G and related actions. A parallel evolution of reporting, standards, and regulation has occurred beyond the US, but this note will be focused on the story in the US.[3]

There is a significant academic literature on the relevance of non-GAAP earnings measure and the impact of Regulation G and related actions. A review of that literature is helpful for identifying lessons that can instruct the discussion on inventory and consequential accounting for Scope 2 emissions.

2 Background

2.1 GAAP and non-GAAP Earnings

Non-GAAP earnings are any statement of earnings not in accordance with standards for GAAP reporting. There are a variety of types non-GAAP earnings which go by different terms. We are primarily concerned with 'pro forma earnings', which is management's own statement of earnings.[4] These are usually disclosed in press releases or earnings announce-

[3]Most recently, see the IFRS project on 'Primary Financial Statements' initiated in 2016 and culminating in IFRS 18, 'Presentation and Disclosure in Financial Statements'.

[4]For a period after the promulgation of Regulation G, there was no comprehensive dataset of management statement of non-GAAP earnings. However, certain data providers such as First Call or I/B/E/S compiled analyst own statements of earnings which sometimes reported non-GAAP measures. These are called street earnings. Due to their ready availability, many studies utilized street earnings to analyze the impact of

ments, but can appear anywhere.

Management's calculation of pro forma earnings most commonly involves adding back to GAAP earnings non-cash, one-off, non-recurrent or other income and expenditure items management considers outside the ordinary course of business. A classic example would be the one-time charges incident to a merger. Those charges must be included in the calculation of GAAP earnings, and omitting them in the calculation of pro forma earnings means that the pro forma earnings exceed GAAP earnings. Non-cash items include the amortization of goodwill and employee stock-based compensation.

Critics point to the inconsistency in deciding what to include and exclude from pro forma earnings. Bradshaw and Sloan 2002 provided the example of Amazon. The company's pro forma earnings for first quarter 2000 "exclude amortization of goodwill and other intangibles, equity in losses of equity-method investees, stock-based compensation costs, and merger, acquisition and investment-related costs," according to the company's press release for April 26, 2000. However, despite excluding equity method losses, Amazon's pro forma earnings include revenue associated with noncash transactions whereby equity-method investees exchange equity securities for advertising and promotional services.

Unsurprisingly, non-GAAP earnings are generally significantly larger than GAAP earnings. For example, in 2014, S&P500 adjustments to GAAP totaled US$132 billion and represented 22% of GAAP net income, according to Ciesielski and Henry 2017.

The practice of non-GAAP reporting began in the mid-1990s and rose ninefold from 1998 to 2006. There was a dip in non-GAAP disclosures in 2002–2003 attributed to the introduction of Regulation G, but the practice expanded again until fully 88% of US S&P500 companies reported non-GAAP earnings. See Bradshaw and Sloan 2002, Black, Black, et al. 2012 and Brosnan et al. 2024.

2.2 The SEC's Regulation G and Related Actions

Prior to passage of the Sarbanes-Oxley legislation, the SEC had already voiced criticism of the increasing use of pro forma earnings. So, too, had the Financial Accounting Standards Board. Nevertheless, firm action arrived in 2003 with Regulation G.

non-GAAP earnings. Eventually, the academic literature did develop good databases of pro forma earnings–notably the sample made available by Bentley et al. 2018–and also explicitly addressed the information to be learned from comparing and contrasting pro forma and street earnings.

Regulation G did not disallow the reporting of pro forma earnings. Instead, it required that companies provide a reconciliation of the non-GAAP metric to the closest GAAP metric. It also restricted management's ability to characterize expenses as non-recurring. Finally, Regulation G and the parallel Reg S-K barred the practice of emphasizing a non-GAAP measure relative to the GAAP measure in US disclosures and SEC filings.

There have been subsequent revisions to Regulation G. Notably, in 2010 the SEC issued a Compliance and Disclosure Interpretation that relaxed the disclosure criteria surrounding recurrent expenditures. Notwithstanding this and other actions, the basic framework remains that non-GAAP measures are permissable, but must be reconciled to a GAAP measure.

3 Evaluating non-GAAP Disclosures and the Impact of Regulation G

The use of non-GAAP metrics has generated controversy. On the one hand, management often insists it is trying to provide investors with better information about the company. Core earnings gross of one-off expenses is more informative of the company's ability to perform going forward, they insist. On the other hand, critics complain about the opportunistic use of non-GAAP metrics, pointing to the inconsistent reporting of non-GAAP metrics and their use to game performance metrics. The former claim is sometimes called the information hypothesis, and the latter the opportunism hypothesis.

Which hypothesis is correct? Are non-GAAP disclosures more informative or are they used opportunistically? What has the research demonstrated?

The research tells a nuanced story. Elements of each hypothesis receive confirmation. The corporate world is diverse. Even a specific company experiences changing fortunes over the course of time. Disclosures can be informative for some at the same time as they are used opportunistically by others. And practice evolves over time.

Did Regulation G fix a broken system, or could it have made matters worse somehow?

Here, too, the story is nuanced and does not fit a simple contrast of the world 'before Regulation G' and the world 'after Regulation G'. The research tells a story of evolution in the capital markets, with investors, management, and regulators all changing through time.

Some non-GAAP earnings do provide useful information to investors. One measure of this is that non-GAAP earnings sometimes have a closer alignment to stock returns than GAAP earnings. The incremental information in non-GAAP earnings is higher for firms for which the GAAP earnings are less informative. When the non-GAAP reconciliations are high-quality–i.e., sufficiently detailed–they reduce market mispricing. See Bradshaw and Sloan 2002, Bhattacharya et al. 2003, Brown and Sivakumar 2003, Choi and Young 2015, Lougee and Marquardt 2004, and Aubert and Grudnitski 2014.[5]

At the same time, it is also clear that firms differ in their use of non-GAAP earnings, with some acting more in line with the informativeness hypothesis and others in line with opportunism. For example, Jennings and Marques 2011 sorts firms according to the quality of their governance which is measured by the number of outside Directors on the firm's Board and by the percent of shares held by institutional investors. They find that earnings adjustments made by firms that score high on both metrics are not persistent–i.e., they are truly non-recurring–while otherwise they are persistent. Choi and Young 2015 find that firms that meet earnings forecasts exhibit high-quality exclusions, apparently using the exclusions to truly inform investors. In contrast, they find that those firms that miss earnings targets adopt low-quality exclusions, apparently using the exclusions because they achieve the targets. Curtis, Mcvay, and Whipple 2014 find that many firms are consistent in their use of non-GAAP earnings, even in periods where the non-GAAP earnings are lower than GAAP earnings, so these firms seem to be trying to provide better information. At the same time, an identifiable set of firms make the disclosures opportunistically. See also Entwistle, Feltham, and Mbagwu 2006. The survey in Brosnan et al. 2024 provides other examples of opportunism documented in the literature.

A large proportion of firms calculate their non-GAAP disclosures differently between periods, which suggests opportunism. However, Black, Christensen, Ciesielski, et al. 2021 find that firms that change the calculation of their non-GAAP earning from one year to the next are improving the informativeness of their disclosures.

The practice of reporting has varied not only across firms, but has also evolved over time. As already noted, Regulation G itself produced only a temporary decline in the use of non-GAAP disclosures. After the temporary dip, use of non-GAAP disclosures has climbed above pre-Regulation G levels.

[5]Brosnan et al. 2024 discusses various statistical criticism of the findings but cites Bradshaw, Christensen, et al. 2018 for having rerun some of the analysis and still finding non-GAAP to be more informative

The nature of non-GAAP disclosures has improved over time, becoming more informative. Overall, the literature agrees that regulations improve the quality of non-GAAP disclosures. US regulations brought about a decrease in emphasis of non-GAAP disclosures relative to GAAP an increase in the quality of reconciliations to GAAP, a decrease in the likelihood of managers using non-GAAP disclosures to meet or beat earnings targets, and an increase in the quality of non-GAAP exclusions. An examination of SEC comment letters sent to firms to address their use of non-GAAP measures in mandatory filings, for example, 10-Ks, 10-Qs, and earnings releases, finds support for regulatory effectiveness. Nevertheless, opportunistic disclosures continue to mislead investors. See Black, Christensen, Ciesielski, et al. 2021, Hribar et al. 2022,Bowen, Davis, and Matsumoto 2005, Entwistle, Feltham, and Mbagwu 2006, Marques 2006, Baik, Billings, and Morton 2008, Zhang and Zheng 2011, Chen 2010, Heflin and Hsu 2008, Jennings and Marques 2011, Black, Black, et al. 2012, Black, Christensen, Kiosse, et al. 2017, Bond et al. 2017,Kolev, Marquardt, and McVay 2008, Chen et al. 2021, Jo and Yang 2020, Barth, Gow, and Taylor 2012, Baumker et al. 2014, Choi and Young 2015, and Curtis, Mcvay, and Whipple 2014.

4 Lessons for Scope 2 Reporting of GHG Emissions

There are obvious parallels between the controversy over non-GAAP earnings and the debate about Scope 2 accounting. Critics of pro forma earnings emphasized the room for opportunism in selecting expenses to include or not. Critics of consequential emissions accounting emphasize room for opportunism in defining the counterfactual scenarios against which impact is measured. Advocates for GAAP earnings emphasized that it was an audited result, just as advocates for inventory accounting emphasize it being auditable. Critics of consequential accounting emphasize the danger of weak and unreliable offsets.

Which Scope 2 accounting for emissions is better, the current metrics designed to inventory a company's own emissions, or alternative 'impact' metrics?

The first lesson from the Regulation G engagements is that this type of 'either/or' framing is too lazy. Just as there is no single, universally correct measure of earnings, so, too, is there no single, best metric for a company's emissions. The SEC's Regulation G never attempted to proscribe the calculation of alternative, non-GAAP measures of earnings. GAAP earnings remained the universally required version. Companies remained free to complement

the GAAP earnings with extra information used to calculate whatever non-GAAP measure the company advocated. By requiring a reconciliation of a non-GAAP measure to the GAAP earnings, and by proscribing any promotion of the non-GAAP measure that would overshadow the GAAP measure, Regulation G encouraged information that would be complementary to the GAAP reporting, as opposed to a substitute for GAAP reporting.

The Protocol has pursued a similar policy going on twenty years now. Where its 'Corporate Standard' implements the inventory accounting which measures the Scope 2 emissions attributable to a company's own operations, its parallel 'Project Protocol' is specifically designed to quantify the emissions impact of a project on the larger system outside the boundary of the company's own operations. Currently, the Protocol requires that any reporting of avoided emissions estimated with project-based accounting methods be disclosed separately from Scope 2 totals calculated using the 'Corporate Standard'. So, looking back to the Salesforce example cited at the top of this note, the emissions impact can, in fact, be reported, but only alongside and as a complement to Salesforce's reporting of its own Scope 2 emission.

The 'Corporate Standard' was published in its original form in 2001, and the 'Project Protocol' in 2005. In the current stakeholder process, the Protocol is so far keeping to this practice of parallel reporting. Revisions to Scope 2 are being evaluated within the framework of inventory accounting of emissions attributable to a company's own operations. Simultaneously, further development of consequential accounting is being evaluated separately. This matches the practice in corporate financial reporting, where GAAP earnings were preserved as a universal requirement that could be complemented with non-GAAP earnings.

A second lesson from the Regulation G engagement is that the parallel disclosure of alternative metrics can help drive improvements in both the quality of reporting and the critical appreciation of the informational content of the reports over time. Regulation G's requirement for reconciliation of non-GAAP earnings to GAAP earnings gave investors tools for evaluating the quality of those reconciliations and thereby to appreciate when non-GAAP earnings were informative.

The inventory accounting at the heart of the Corporate Standard tracks emissions at the company level, where the relevant data is more readily at the disposal of the reporting organization and its inventory is therefore more readily auditable. Consequential or impact accounting looks to the larger system, and employs counterfactual scenarios about events beyond the corporate boundary. The two approaches face different data challenges. We saw

that in the case of non-GAAP earnings some companies did indeed calculate higher quality earnings figures, but also companies that behaved opportunistically to game the reports. I would similarly expect to see examples of significant impact based on sensible counterfactuals alongside other examples that claim outsized impact based on unreasonable counterfactuals. Preserving the Corporate Standard's inventory and requiring a separate reporting of Project Protocol impact will drive an improved understanding of each over time, and raising the quality of the counterfactuals and therefore of the impact. Separate reports on the two enables users of the reports to scrutinize each and to engage in a dialogue about the validity of the counterfactuals or of the relevance of the inventory. In turn, this can encourage company's to improve the quality of both the inventories and the counterfactuals.

If consequential emissions reductions were netted together with Scope 2 inventory emissions, then it would be that much more difficult to scrutinize and evaluate each component. Keeping the two separate gives users of the accounting more information. Just as the quality of any company's non-GAAP earnings is measured as a complement to the universal requirement of GAAP earnings, so, too, a company's impact can be evaluated against a universal requirement for emissions inventory accounting.

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