CHAPTER 2

US GAAP updates - SEC's focus on ESG and SPAC disclosures

This article aims to:
Provide an overview of the recent accounting and financial reporting developments under the US GAAP relevant for the companies in the current period or near term.

In this article, we shall focus on some of the guidance/disclosures released by the U.S. Securities and Exchange Commission (SEC) relating to climate and Environmental, Social and Governance (ESG) disclosures, Special Purpose Acquisition Companies (SPACs) related disclosures, clarifying what is income in connection with the income test at the time of disposition of business and Public Company Accounting Oversight Board's (PCAOB's) conversation with the audit committee chairs of companies during 2020 inspection cycle.

Climate and ESG related disclosures

ESG refers to a framework to integrate environmental, social and governance risks and opportunities into a company's strategy. ESG is playing an increasingly important role in the strategy and operations of companies, and investment decisions are increasingly being driven by ESG metrics.

On 24 February 2021, SEC Acting Chair, Allison Herren Lee issued a statement which indicated that the SEC Division of Corporation Finance will enhance its focus on climate-related disclosure in public company filings. Specifically, the SEC staff will review the extent to which a company's disclosures address the 2010 interpretive guidance on climate change-related disclosures, assess companies' compliance with disclosure obligations under the federal securities laws, and develop an understanding of how the market is managing climate-related risk. The staff will use these insights to update the 2010 guidance.

Following Lee's statement, on 4 March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement that will develop initiatives to identify ESG-related misconducts. The task force's initial focus will be on material gaps or misstatements in a company's disclosures on climate risks and ESG issues under existing rules. The task force will also analyse disclosure and compliance issues relating to investment advisers' and funds' ESG strategies.

The SEC's announcement is a call to action for registrants to refresh their understanding of the 2010 disclosure guidance-which explains how the Regulation S-K requirements apply to climate-related matters-and to carefully analyse the quality of their disclosures.

Current reporting requirements under 2010 SEC's interpretive guidance

The guidance released in 2010 highlighted various Regulation S-K disclosure requirements that may be relevant to climate-related matters. These disclosures summarise the risks, events or circumstances that are material to an investor's understanding of the registrant's business, including the following:

- **Item 101, *Description of Business*:** It requires a narrative description of the business, including disclosure of the material effects that compliance with federal, state and local environmental laws may have on the capital expenditures, earnings and the registrant's competitive position.
- **Item 103, *Legal Proceedings*:** It requires a description of material pending legal proceedings, including matters arising from federal, state or local laws intended to protect the environment.
- **Item 105, *Risk Factors*:** It requires disclosure of the material factors that make an investment in the registrant speculative or risky.
- **Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations*:** It requires disclosure of known trends or uncertainties that have had or are reasonably likely to have a material impact on the registrant's continuing operations and known material events and uncertainties that are reasonably likely to cause the financial information not to be indicative of future operating results or financial condition.

Potential impact of disclosure requirements

The SEC staff cited following areas where climate change may require disclosure as per its 2010 guidance:

- **Impact of legislation and regulation:** A registrant should consider the impact of existing and pending climate-change laws and regulations. If material, it should also consider the difficulties of assessing the timing and effect of pending legislation and regulation; both positive and negative consequences of actual or pending legislation or regulatory actions should be considered. Some of these possible consequences include:
  - Costs to purchase, or profits from sales of, allowances or credits under a cap-and-trade system
  - Costs required to improve facilities and equipment to reduce emissions to comply with regulatory limits or to mitigate the financial consequences of a cap-and-trade regime
  - Changes to profit or loss arising from increased or decreased demand for goods and services produced by the registrant arising directly from legislation or regulation, and indirectly from changes in costs of goods sold.
- **Impact of international accords:** A registrant should consider the risks or effects of international accords and treaties related to climate change. The disclosure requirements for foreign legislation and regulation are the same as for domestic and should include both negative and positive consequences.

  For example, the Paris Climate Agreement was adopted by 196 countries, but each country is responsible for developing its own plans for climate action. This means that companies with multinational operations should fully understand the environmental actions wherever they operate to evaluate possible negative or positive consequences.
- **Indirect consequences of regulation or business trends:** A registrant should evaluate the legal, technological, political and scientific developments related to climate change, or other trends in the business environment that may directly or indirectly pose risks or create new opportunities. Some of the indirect negative consequences or opportunities might include:
  - Decreased demand for goods that result in significant greenhouse gas emissions.
  - Increased demand for goods that result in lower emissions than competing products
  - Increased competition to develop innovative new products.

  Companies need to consider where the indirect consequences or opportunities should be disclosed. For example, if a company plans to take advantage of potential opportunities through material acquisitions of plant or equipment, disclosure may be required by Item 101. The potential impact of business trends or risks may need to be disclosed in Items 105 or 303.
- **Physical impact of climate change:** Significant physical effects of climate change e.g., severity of the weather, rising sea levels, the arability of farmland, water availability and quality, scarcity of resources have the potential to affect a registrant's financial condition and business.

  Companies should consider both the actual and potential impact of environmental matters stemming from climate change to their business and operations including personnel, physical assets, and supply and distribution chains.

SPACs – Disclosure considerations

A SPAC is a company with no operations that offers securities for cash and places substantially all the offering proceeds into a trust or escrow account for future use in the acquisition of one or more private operating companies. Following its Initial Public Offering (IPO), the SPAC will identify acquisition candidates and attempt to complete one or more business combination transactions after which the company will continue the operations of the acquired company or companies (combined company) as a public company.

The economic interests of the entity or management team that forms the SPAC (sponsor(s)) and the directors, officers and affiliates of a SPAC often differ from the economic interests of public shareholders which may lead to conflicts of interests as they evaluate and decide whether to recommend business combination transactions to shareholders. Clear disclosure regarding these potential conflicts of interest and the nature of the sponsors', directors', officers' and affiliates' economic interests in the SPAC is particularly important because these parties are generally responsible for negotiating the SPAC's business combination transaction. Unlike the traditional IPO process where a private operating company sells its securities in a manner in which the company and its offered securities are valued through market-based price discovery, these individuals are solely responsible for deciding how to value the private operating company and how much the SPAC will pay for it.

The staff of the SEC Division of Corporation Finance has issued guidance about disclosure considerations for SPACs in connection with their IPO and subsequent business combination transactions.

In accordance with the guidance issued by SEC, a SPAC preparing to conduct an IPO or present a business combination transaction to shareholders should consider carefully its disclosure obligations under the federal securities laws as they relate to conflicts of interest, potentially differing economic interests of the SPAC sponsors, directors, officers and affiliates and the interests of other shareholders and other compensation-related matters.

The SEC highlighted certain considerations for a SPAC while preparing to conduct an IPO or present a business combination transaction to its shareholders. These are as follows:

Disclosure considerations - IPO

- Relationships that the sponsors, directors and officers have with other entities which may be target acquirees of the SPAC.
- Financial incentives of SPAC sponsors, directors and officers to complete a business combination and/or possible losses for failure to complete a business combination, including quantitative information to the extent practicable.
- Amount of control that the sponsors, directors and officers have over approval of a business combination.
- Ability for the SPAC to amend its governing documents to facilitate the completion of a business combination or extend the period of time it has to complete the transaction.
- Deferral of compensation owed to underwriters of the SPAC IPO and any additional services to be provided by such party relating to the identification of a target acquiree (e.g. financial advisor, placement agent in a private offering, arranger of debt financing).
- Economic terms of the investments made by SPAC sponsors, directors, officers and their affiliates, including security ownership, compensation arrangements or relationship with affiliated entities.

Disclosure considerations – Business combinations

- Terms of additional financing necessary to complete the business combination and how the terms may impact the public shareholders.
- Approach taken to evaluate and decide to proceed with the identified transaction including how alternative targets may have been considered.
- Material factors that the board of directors considered in approving the identified transaction and the price paid to acquire the target operating company.
- Conflicts of interest of the sponsors, directors, officers and affiliates in presenting the opportunity to the SPAC, and how the SPAC addressed such matters.
- Qualitative and quantitative information about the consideration that the sponsors, directors, officers and their affiliates will receive upon completion of the transaction and the retained ownership they will have in the combined entity.
- Underwriting fees payable upon the completion of the business combination and the additional services the underwriter provided.

Determining 'income' for the income test in connection with the disposition of a business

The Center for Audit Quality (CAQ) SEC Regulations Committee asked the SEC staff to provide its view on how the numerator of the income test of significance should be calculated in connection with the disposition of a business. As per the SEC staff, the numerator should be calculated based on the income statement effects that would be removed from the registrant's income statement during the tested period (similar to the requirements for presenting discontinued operations under ASC 205-20-45), rather than determining pre-tax income on a carve-out basis.

Conversations with audit committee chairs

The PCAOB released a summary of their conversations with audit committee chairs of almost 300 US issuers whose audits they inspected in 2020. The conversations focus broadly on how COVID-19 created unprecedented challenges for auditors, audit committees and public companies. In addition to the effects of COVID-19 pandemic on the audit, PCAOB discussed following three core topics:

- Auditor and communications with the audit committee
- New auditing and accounting standards and
- Emerging technologies.

This section summarises the discussion under each of these heads.

Auditor and communications with the audit committee

Audit committee chairs frequently cited communications with their auditors-both verbal and written-as extremely important to audit quality and their overall relationship with their auditors. Most audit committee chairs commended their auditors' communications, commonly sharing that they were thorough, timely, and at the right level of detail and frequency. Several also highlighted their appreciation for dashboards provided by their auditors that highlighted real-time data on audit progress and other topics.

Audit committee chairs noted that their auditors performed well in areas such as assigning resources with expertise on complex accounting issues, consulting their national offices as appropriate, offering practical approaches to problem-solving (as opposed to being highly theoretical), and providing continuity on audit teams.

Innovation and partner rotation were areas where some audit committee chairs praised their auditors, but others flagged them as areas needing improvement. Other potential areas of improvement that were identified included:

- Managing global audit operations
- Helping more junior audit team members learn the company's business
- Independence communications
- Guidance around auditing of certain controls for third-party vendors
- 'Over-auditing' and/or 'over-documentation' and
- Increased visibility into and discussion around fee changes.

The PCAOB sought to gauge the understanding of audit committee chairs about the activities or initiatives that they observed audit firms undertaking to prevent audit deficiencies, which is a significant area of strategic focus for the PCAOB. Their responses largely centered on the following:

- Audit firms' use of emerging technologies
- Audit firms' emphasis on tone at the top
- The role of robust training as a guard against deficiencies and
- The importance of auditors staying focused on implementation of new accounting and auditing standards.

New accounting and auditing standards

Audit committee chairs oversaw implementation of a variety of new accounting standards during the period covered by PCAOB's 2020 inspections. New accounting standards for revenue recognition, lease accounting, and where applicable, preparing for implementation of Current Expected Credit Losses (CECL), stood out as particularly challenging and time consuming for many audit committee chairs.

Implementation of the Critical Audit Matter (CAM) requirements by auditors was generally viewed as smooth, with audit committee chairs noting that dry runs and other early preparation with their auditors led to few surprises.

The PCAOB's new requirements related to auditing accounting estimates, including fair value measurements, and using the work of specialists took effect for audits of fiscal years ending on or after 15 December 2020. PCAOB observed that the audit committees have not yet discussed the new requirements in detail with their auditors.

Emerging technology

Many audit committee chairs cited the potential benefits from the use of emerging technologies to improve both the audit and overall financial reporting quality. Specifically, they shared their belief that the use of data analytics, workflow automation, cloud computing, and other tools will allow auditors to reduce manual work, obtain better evidence, and become more efficient. Other audit committee chairs noted that technology, if deployed properly, can (1) cut down on opportunities to manipulate or falsify financial information and (2) provide auditors with the ability to more easily identify anomalies.

On the other hand, audit committee chairs also discussed numerous challenges associated with emerging technologies. For example, several audit committee chairs highlighted the gap between the technological capabilities of the company and those of the audit firm. While some audit committee chairs noted that their companies had more sophisticated technology than their auditors, others said the opposite. Either way, audit committee chairs largely agreed that companies and auditors need similar levels of technological capabilities for the benefits of using emerging technologies to be fully realised.

Audit committee chairs were also wary of the risks that come with emerging technologies. They commonly flagged cybersecurity risk as the thing that keeps them up at night, especially with the shift to remote work during the COVID-19 pandemic. Another risk cited was overreliance on technology leading to less attention to or emphasis on preparer and auditor judgement, experience, or professional skepticism.

Finally, concerns were expressed about technology unknowns, given that many technologies have only recently been adopted or put into use. The audit committee chairs noted that while the benefits of emerging technologies are often immediately clear, the risks involved can take longer to become apparent or to understand.

(Source: Quarterly Outlook, KPMG in the US, March 2021, SEC's Disclosure Guidance Topic No 11 on Special Purpose Acquisition Companies dated 22 December 2020 and PCAOB's 2020 Conversations with Audit Committee Chairs issued in February 2021)