

## Chapter 1

# US GAAP: SEC and PCAOB developments

### This article aims to:

Provide an overview of key areas of focus under US GAAP and related auditing matters as discussed in the annual AICPA 2021 conference.

### Introduction

In December 2021, the American Institute of CPAs (AICPA) and CIMA (Chartered Institute of Management Accountants) held its annual conference on current SEC<sup>1</sup> and PCAOB<sup>2</sup> developments. Environmental, Social and Governance (ESG) reporting and related matters was an overarching theme of the conference. Further, SEC's Acting Chief Accountant, Paul Munter, outlined three elements necessary to support high quality financial reporting – high quality standard-setting, high quality implementation and application of those standards, and high-quality audits.

In this article, we aim to cover key areas of focus as discussed at the conference relevant for companies following US GAAP.

### ESG reporting and related regulatory developments

#### *Need and imperative for ESG reporting*

Many companies have been providing sustainability reporting in some form over a number of years. However, there is currently disparity in practice as to where and how that information is disclosed and the level of assurance over that information, if any.

Also, many companies may not have processes and controls when preparing and reporting ESG information. Therefore, sustainability reporting today under different voluntary frameworks does not meet investors' need for consistent, comparable and reliable information, particularly when compared to the well-established disclosures, controls and procedures over financial information.

There have been concerns about 'green washing' (whereby a registrant over-emphasises its environmental contribution compared to its true actions) and questions about the completeness and accuracy of data are common in sustainability reporting.

Therefore, significant support is growing from investors and companies alike for a global set of baseline standards around sustainability reporting. Accordingly, to respond to the demand for a consistent set of standards, in November 2021, the IFRS Foundation announced formation of the International Sustainability Standards Board (ISSB) to develop sustainability standards. The ISSB aims to issue the first international sustainability disclosure standards by late 2022 (focused on general disclosure requirements and climate).

1. U.S. Securities and Exchange Commission  
2. Public Company Accounting Oversight Board

A mandatory climate risk disclosure rule is expected to be issued by SEC in early 2022 wherein the SEC staff shall consider whether ESG disclosures should be required as part of a registrant's periodic SEC filings. In 2020, the SEC amended Regulation S-K with a principles-based approach to require registrants to disclose in the 'Description of Business' section of periodic filings how management manages the business from a human capital standpoint. As part of its current rulemaking agenda, the SEC will develop further human capital disclosure guidance, which is expected to be more prescriptive.

An additional proposal on cybersecurity risk disclosure requirements is anticipated in 2022. The SEC believes there should be a continued focus on understanding cybersecurity risks, a registrant's control structure, and timely communication within an organisation of cyber events.

#### *Role of an auditor in sustainability reporting*

The speakers noted that to date many of the independent reviews have been performed by engineering and consulting firms. However, they noted that the audit firms are well positioned to provide assurance over ESG information given their

understanding of a registrant's business, operations, and financial reporting processes and controls, which may overlap or share many similarities with the processes and controls used to prepare ESG information. Further, auditors are subject to well-established professional standards, independence requirements, and systems of quality control.

Internationally, the International Organisation of Securities Commission (IOSCO), of which the SEC is a member, has expressed support for assurance of ESG metrics and disclosures to enhance reliability of such metrics. IOSCO would be looking at assurance frameworks in 2022.

#### *Next steps*

Companies are encouraged to take steps now to prepare for ESG related reporting. While doing so, companies may consider:

- Who has ownership of ESG data within the organisation
- Processes, and controls of preparing ESG information and whether they overlap or differ from the financial reporting processes and controls
- What level of governance and oversight exists with reference to sustainability reporting processes and controls?

A strong understanding of their current ESG reporting infrastructure, processes and controls will help companies when new standards and requirements are proposed in the near future.

#### **SPACs: New trend in capital formation**

In a SPAC<sup>3</sup> transaction, a shell (or 'blank check') company is formed that registers with the SEC to become public. This company searches for a private operating company to acquire it. Once acquired by the SPAC, the operating company becomes a public company without going through the traditional IPO<sup>4</sup> process. The increased popularity of using SPACs in the US capital markets has attracted significant attention from the SEC in the past year.

The OCA staff provided further updates on certain accounting matters related to SPACs. Those relate to the following:

- **Indexation:** The issue relates to SPAC warrants with provisions that provide for potential changes to the settlement amounts depending upon the characteristics of the holder of the warrant. In such a case, the OCA staff concluded that if the settlement amount varies depending on who holds the warrant, it does not meet the indexation requirements under US GAAP. Therefore, the warrants should be classified as a liability measured at fair value.

Further, the OCA staff had evaluated other fact patterns, including certain warrants (often referred to as public warrants) that the registrant considered to be indexed to the entity's own stock and therefore, qualified for equity classification. These warrants did not have any variability in settlement amounts depending on who held them and there were no other features that precluded the warrants from being considered indexed to the entity's own stock. Therefore, the public warrants qualified for equity classification.

- **Tender offer provisions:** The issue relates to SPAC warrants that entitle all warrant holders to receive cash if a tender or exchange offer is made to and accepted by holders of more than 50 per cent of the outstanding shares of a single class of common stock. In certain multiple class share structures, such a tender offer may not result in a change in control of the entity. If a qualifying cash tender offer does not result in a change in control, all warrant holders would be entitled to receive cash, but only certain holders of the underlying shares of common stock would be entitled to receive cash. For this reason, the OCA staff objected to the warrants being classified as equity.

3. Special Purpose Acquisition Companies

4. Initial Public Offer

The OCA staff had also evaluated a different fact pattern in which cash settlement for the warrants is triggered only upon a change in control and the holders of the shares underlying the warrants would also receive cash for their shares. As a result, the registrant concluded that the warrants qualified to be classified as equity. The OCA staff did not object to this conclusion.

- **Unit of account analysis in relation to temporary equity classification:** Under SEC guidance, if an equity-classified instrument could be redeemed upon the occurrence of an event outside a registrant's control, that instrument is required to be classified outside of permanent equity. This classification is commonly referred to as temporary equity or mezzanine equity. The classification of a SPAC's equity is an issue because a SPAC is typically structured so that its issued shares will become redeemable either

when the SPAC completes a merger with a target entity within a specific time period or when the SPAC dissolves without a target to complete a merger.

The OCA staff had evaluated a fact pattern in which a registrant believed that a portion of its shares could be classified as permanent equity because of a provision in its charter that stated a redemption would not occur if it caused net tangible assets to decline below a certain threshold amount. Notwithstanding the fact that each share was freestanding from the other shares and each share was separately redeemable, the registrant believed that the provision in the charter provided a basis to evaluate a pool of shares as the unit of account, instead of evaluating each individual share as a unit of account. Under this approach, the registrant concluded that any shares

that would cause the net tangible assets to fall below the threshold amount could be classified as permanent equity in its entirety.

The OCA staff objected to the registrant's conclusion because it did not agree that there is a basis under US GAAP or SEC guidance to consider the pool of a class of shares as the unit of account instead of an individual share. As a result, the OCA staff concluded that each share was required to be classified as temporary equity.

## Materiality and restatements

'Big R' restatements refer to restatement of prior-period financial statements whereas 'little r' restatements refer to errors corrected in current-period comparative financial statements by restating the prior-period information, without reissuing the prior-period financial statements. A 'Big R' and 'little r' are both accounting restatements, the difference being the presentation of the restatement.

The key issue in distinguishing between a 'Big R' and 'little r' restatement is materiality. The preparers and auditors should apply the framework from Staff Accounting Bulletin Topic 1.M, *Materiality* (SAB 99) when determining whether a restatement is a 'Big R' or a 'little r' restatement. Following should be noted:

- If an error is quantitatively material, then registrants should be cautious in concluding that qualitative factors would be able to overcome the magnitude of the error that would allow a registrant to conclude that the restatement to correct the error is a 'little r' restatement. Magnitude often cannot be overcome by qualitative factors.
- If an error is quantitatively immaterial, then qualitative factors should be carefully analysed because the combination of the quantitative and qualitative factors could make the restatement to correct the error a 'Big R' restatement.

Also, if a registrant has a quantitatively material error, then it is likely to impact Internal Control over Financial Reporting (ICFR) as a material weakness. However, even if a registrant has a 'little r' error, it could still have a material weakness.

### SEC: Other areas of focus

- **Spring-loaded share-based compensation awards:** The SEC staff issued Staff Accounting Bulletin No. 120 (SAB 120)<sup>5</sup> to provide interpretive guidance on accounting for grants of share-based payment awards under FASB ASC Topic 718, *Accounting for Stock Compensation* when the issuer has knowledge of material non-public information (commonly referred to as 'spring-loaded awards'). In accordance with the guidance, material non-public information can impact the grant date fair value of spring-loaded share-based payment awards. The guidance also expresses an expectation that a registrant discloses any adjustments made to its share price or share price inputs because of spring-loaded share-based payment awards.

The SEC staff indicated that non-routine spring-loaded grants merit particular scrutiny by those responsible for compensation and financial reporting governance at registrants. As these registrants measure compensation actually paid

to executives, they must consider the impact that material non-public information will have upon release.

- **Reference rate reform:** Many LIBOR tenors will cease being published on 31 December 2021 and LIBOR will be phased out completely on 30 June 2023. There is temporary relief under FASB ASC Topic 848 (reference rate reform) that allows an entity to adopt optional expedients regarding contract modification accounting and elective hedge accounting expedients when LIBOR is replaced as the reference rate in a contract. Topic 848 establishes elective hedge accounting expedients, including those that allow an entity to change certain critical terms of existing hedging relationships that are affected or expected to be affected by reference rate reform without causing the entity to de-designate the hedging relationship because of those changes.

Topic 848 applies only to modifications related to reference rate reform and hedging relationships that are affected by such reform.

Registrants affected by reference rate reform need to have appropriate processes and controls in place when applying Topic 848. Further, they should confirm that their systems are able to handle the new rate environment.

- **Non-GAAP reporting:** The SEC staff emphasised three key issues it has identified involving non-GAAP reporting:

**a. Prominence:** When a registrant presents a non-GAAP measure, it must present the most directly comparable GAAP measure with equal or greater prominence. The SEC staff gave the example of how a lengthy discussion of a non-GAAP measure (including charts and graphs) can inappropriately overshadow the GAAP measure.

**b. Mislabelling:** A registrant should not use terms for non-GAAP measures that are too similar to GAAP terms. The title of a measure should match its description. The SEC staff gave the example of labelling a non-GAAP measure 'core earnings' but excluding cost of revenue line items or other expenses. Further, a registrant should adequately describe all of the adjustments it is making to a measure.

**c. Metrics versus non-GAAP measures:** When a registrant discloses a financial or non-financial metric to describe the performance of its business, it must determine if the metric is actually a non-GAAP measure. The SEC staff acknowledges that the line between a metric

5. Issued on 29 November 2021

and a non-GAAP measure can be blurry, but the distinction will assist in determining which disclosure guidance applies.

- **Segment reporting:** The SEC staff reminded registrants to consider the impact that changes to their business, executives or operations may have on segment reporting. Both US GAAP and IFRS require disclosing the measure of profit and loss for each reportable segment that is reviewed by the chief operating decision maker or is otherwise regularly provided to the chief operating decision maker. Any other profit and loss measure that a registrant wants to disclose should appear outside of the financial statements and could be considered a non-GAAP measure.

### Digital assets

The accounting of digital assets continues to be a complex and fast-evolving area, raising several issues. The SEC staff's view is that digital assets that are not considered securities or subject to other specific guidance should be accounted for as intangible assets. Although there are existing

models to account for digital assets, it was noted that investor community is looking for more guidance from the FASB on how these assets should be defined and accounted for. The FASB may add a project to its technical agenda to address the accounting for digital assets.

### Audit - Data and technology

Advancements in technology allow auditors to access an expanded breadth and depth of data, and auditors may use more external sources of information when performing audit procedures. While the use of data and technology has the potential to improve audit quality, auditors' abilities to obtain appropriate data sets remains a challenge. It is to be noted that the use of technology does not diminish the importance of requirements in the risk assessment standard, and certain audit procedures may not lend themselves to the use of technology (e.g., the need for an auditor to hold key discussions with an audit committee and inquiries of management).

The PCAOB staff expects to continue to focus on audit risk driven by the current economic

environment and recent changes, which may present increased audit risks and the risk of fraud for certain registrants. Examples include:

- Valuation estimates and accounting complexities associated with the high level of IPOs and merger and acquisition activities, including SPACs and de-SPAC transactions and
- Asset impairments and going concern risks associated with widespread disruption of supply chains and the continued negative effect of COVID-19 on certain industries.

Additionally, PCAOB will focus on audit firmwide risks, including the heightened degree of staff turnover and potential risks to a firm's independence related to the sale and delivery of non-audit services.

*(Sources: Quarterly Outlook, December 2021, KPMG US and SEC Issues & Trends, December 2021, KPMG US)*