Audit Committee Quarterly Update

SECOND QUARTER 2021

In this newsletter, we highlight some important 2021 second quarter issues facing audit committees. The content is not all-inclusive. You may also be interested in our quarterly publication that summarizes accounting, financial reporting, and regulatory matters that may impact both public and private companies.

Special purpose acquisition companies

The increase in special purpose acquisition companies (SPACs) and the related acquisition transactions has continued to attract attention from regulators. SPACs have recently increased in popularity as they provide quick access to the capital markets. The use of SPACs raises complex financial reporting and governance considerations.

In May 2021, the Center for Audit Quality (CAQ) issued Alert 2021-01, Auditor and Audit Committee Considerations Relating to SPAC Initial Public Offerings and Mergers, which provides a good summary of the various phases of a SPAC transaction along with specific considerations auditors, audit committees, and management of private companies preparing to go public through a SPAC should consider prior to and during the transaction.

Management and audit committees of private companies determining whether to "go public" via a SPAC transaction should consider the following (not all-inclusive):

- Public company readiness
- SPAC sponsor experience
- Corporate governance
- Accounting, reporting, and disclosure issues
- External auditor selection and oversight

This alert contains questions for each of the above areas of consideration. Audit committee oversight is critical prior to, during, and after a SPAC merger transaction as it shares responsibility for assessing auditor independence, overseeing the public company's financial reporting and internal controls over financial reporting (ICFR) requirements, and overseeing the external audit. It's not uncommon for SPAC merger filings to disclose a material weakness in ICFR. The CAQ recommends that audit committees engage with the external auditor and understand the considerations for auditors that are also included in this alert.

In April 2021, the SEC issued a statement that certain warrants issued by a SPAC should be classified as liabilities rather than equity. They noted that while the specific terms of these warrants can vary, certain features of warrants issued in SPAC transactions may be common across many entities. Warrants classified as liabilities rather than equity must be measured at fair value, with changes in fair value included in net income each period. The statement also discussed the financial reporting considerations that apply if a registrant and its auditors determine there is a material error in any previously filed financial statements. This statement has resulted in many restatements as well as some companies choosing to modify their warrants prior to the SPAC IPO process. We suggest that management and audit committees carefully consider the statement and the potential implications when determining the accounting treatment for warrants issued in a SPAC transaction.

Climate and environmental, social and governance (ESG) disclosures

In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement. The initial focus of the task force will be to identify any material gaps or misstatements in issuers' disclosures of climate risks under existing rules. The task force will also analyze disclosure and compliance issues relating to investment advisors' and funds' ESG strategies and work closely with other SEC divisions and offices, including the Divisions of Corporation Finance, Investment Management, and Examinations.

In June 2021, the SEC's new chair, Gary Gensler, commented that he has asked SEC staff to put together recommendations on mandatory company disclosures on climate risk and human capital. He indicated that the SEC may require public companies to publish data on a whole range of new areas, including greenhouse gas emissions, workforce turnover, and diversity.

Human capital disclosures will build on prior SEC disclosure updates and could include a number of metrics, such as workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety.

In May 2021, SEC Commissioner Allison Herren Lee delivered keynote remarks at the 2021 ESG Disclosure Priorities Event hosted jointly by the CAQ, AICPA, the Chartered Institute of Management Accountants, and the Sustainability Accounting Standards Board (SASB). She urged attendees to submit comments to the SEC as it plans new ESG disclosure rules and also addressed what she believes are four myths and misconceptions related to materiality as it pertains to climate and ESG disclosures. They are summarized as follows:

- **Myth #1:** ESG matters (indeed all matters) material to investors already are required to be disclosed under the securities laws. She believes that this is a myth and stated that climate and ESG information important to a reasonable investor isn't necessarily required to be disclosed simply because it is material.

- **Myth #2:** Where there is a duty to disclose climate and ESG matters, we can rest assured that such disclosures are being made. In contrast to this myth, she believes that a disclosure system that lacks sufficient specificity and relies too heavily on a broad-based concept of materiality will fall short of eliciting information material to reasonable investors.
- **Myth #3:** SEC disclosure requirements must be strictly limited to material information. In contrast to this myth, she believes that the idea that the SEC must establish the materiality of each specific piece of information required to be disclosed in SEC rules is legally incorrect, historically unsupported, and inconsistent with the needs of modern investors, especially when it comes to climate and ESG.
- **Myth #4:** Climate and ESG are matters of social or "political" concern and not material to investment or voting decisions. She believes that this is a myth and stated that the SEC is increasingly seeing all manner of market participants embrace ESG factors as significant drivers of decision-making, risk assessment, and capital allocation precisely because of their relationship to firm value.

Lease accounting: The time is now for nonpublic companies

In 2020, the FASB approved the deferral of the effective date for ASC 842 to Jan. 1, 2022, for calendar year-end nonpublic entities. While many entities have taken advantage of the deferral, those that have already adopted ASC 842 consistently indicate the implementation process was more time-consuming than initially anticipated. Much of the implementation process and lease contract analysis is manual in nature and can place constraints on the organization's resources. We recommend that the audit committee work with management to develop and monitor the adoption implementation plan in order to avoid a potential rush to the deadline.