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A Closer Look

Financial reporting considerations for Special Purpose Acquisition Companies

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In a number of jurisdictions, Special Purpose Acquisition Companies (SPACs) are becoming an increasingly common alternative to traditional initial public offerings (IPOs) for private companies seeking to raise capital.

Although the structures of SPACs and the transactions they undertake with private companies differ, they typically share a number of features giving rise to financial reporting issues which may require careful consideration.

What is the structure and lifecycle of a typical SPAC?

A SPAC is typically a 'shell' company formed by a management team or sponsor for the sole purpose of raising cash via an IPO. The cash raised (and/or the equity of the SPAC itself) is then used to fund the acquisition of a 'target' company.

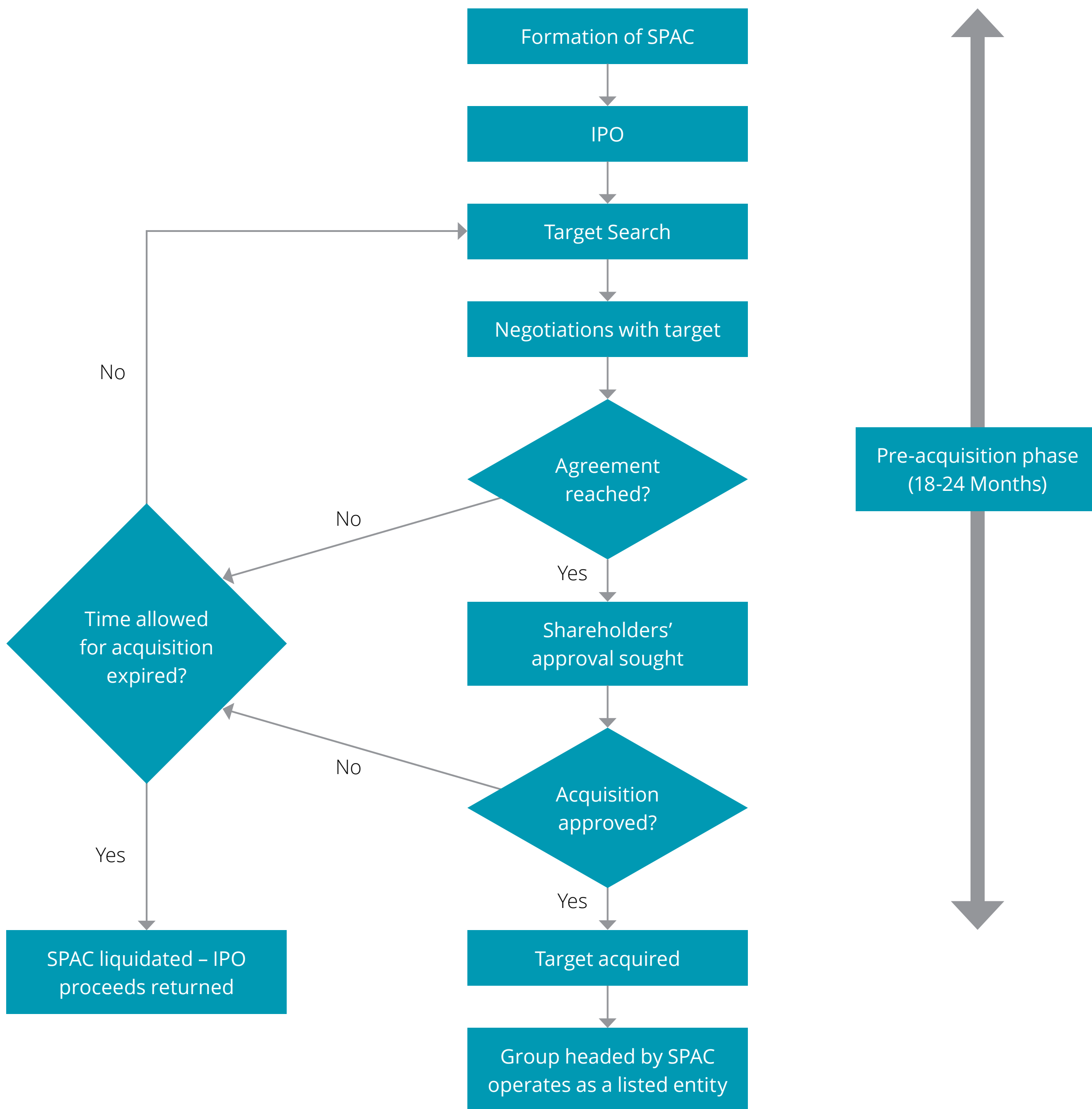
The capital structure of a SPAC can differ, but often includes:

- 'Class B' or 'Founder' shares issued to the management team or sponsor on formation of the company.
- 'Class A' shares and warrants to purchase further shares issued to public shareholders upon IPO (typically, subscribers to the IPO will be offered 'units' consisting of a share plus a fraction of a warrant). The 'Class A' shares and warrants are then traded on a public market (either separately or as a combined unit).
- Warrants to acquire 'Class A' shares purchased by the management team or sponsor, separately from the IPO.

A SPAC's IPO is typically supported by an investment thesis indicating, for example, the industry or geography of the target company to be acquired and specifying that if no such acquisition is completed within a defined time period (often 18-24 months), then unless an extension to the permitted time is agreed the SPAC will be liquidated and the IPO proceeds returned to the investors. Investors may also have the ability to redeem their 'Class A' shares immediately before an acquisition and/or upon approval of an extension to the time permitted to complete an acquisition.

Between an IPO and completion of an acquisition, the SPAC will typically have no assets or activities beyond cash held in a trust account and the search for a suitable target company. Once such a target is identified, the acquisition generally requires shareholders' approval (some sponsors retain the right to commit the SPAC to an acquisition). If approved, the acquisition effectively results in the target company continuing its previous activities under its existing management (the SPAC management team may or may not have some involvement subsequent to the acquisition) but now with a public company as the parent.

The lifecycle of a typical SPAC can, therefore, be illustrated as below.



What financial reporting issues require consideration during the life of a SPAC?

As illustrated above, the lifecycle of a typical SPAC might be summarised as a 'pre-acquisition phase', followed by the acquisition of a target company (assuming that is achieved within the allotted time), followed by a post-acquisition phase in which the SPAC is the parent entity of a 'normal' publicly quoted group. Although financial reporting issues can span each of these phases, many are specific to one of those three stages.

Prior to acquisition of a target company

Before the acquisition of a target company, the financial statements of a typical SPAC include only a limited number of balances, largely relating to the issuance of various financial instruments. The accounting for these instruments can be complex, requiring careful consideration of the scope and requirements of IFRS Standards[1]. In particular, as summarised below, the classification of shares and warrants as either liabilities or equity can be challenging.

[1] SPACs established for listing in the United States typically apply U.S. GAAP. The requirements of that framework are discussed in Financial Reporting Alert 20-6 – Accounting and SEC reporting considerations for SPAC transactions, published by Deloitte in the U.S.

Instrument	Issued on	Typical features	Factors to consider when assessing liability vs equity classification
'Class B' or 'Founder' shares	Formation of the company	• May be issued to the holder in exchange for services or purchased for cash. • Non-redeemable by the holder, receive no proceeds upon liquidation due to a failure to complete an acquisition. • Convert into 'Class A' shares upon acquisition of a target company. In some cases, the holder can elect to convert before completion of such an acquisition.	As noted below, it is first necessary to determine whether the shares should be treated as financial instruments (applying IAS 32 *Financial Instruments: Presentation*) or are, as might often be the case for shares issued to employees, within the scope of IFRS 2 on share-based payments. If in the scope of IAS 32, it is then necessary to consider whether there is any variability in the number of 'Class A' shares into which each 'Class B' share converts that would breach the 'fixed-for-fixed' criterion in IAS 32 and result in classification as a liability or whether (as discussed below in respect of warrants over 'Class A' shares), conversion can occur at a time when the 'Class A' shares themselves are classified as liabilities.
'Class A' shares	IPO	Often contain redemption provisions along the lines of the following: • If the SPAC does not complete the acquisition of a target company by a specified date after the IPO, the shares will automatically be redeemed for a specified amount of cash and the SPAC will then be liquidated. • If the SPAC completes an acquisition, holders have the right to redeem their shares for a specified amount of cash immediately before that transaction, subject to the SPAC maintaining a minimum amount of assets. The precise terms of these provisions can, however, differ significantly in respect of: • The mechanism by which an investor can choose to redeem their 'Class A' shares for cash instead of retaining an investment in the SPAC following completion of an acquisition. For example, the redemption right might be exercisable at different times and may or may not be linked to whether an investor votes to approve a proposed acquisition. • The mechanism by which capital is returned to investors in the event that an acquisition does not occur. For example, this might be via liquidation of the SPAC or prior to that event and might happen automatically in the event that an acquisition has not been completed by a given date or a shareholder vote might be necessary to trigger (or delay) redemption. After the completion of the acquisition of a target company, the redemption features on the 'Class A' shares generally lapse.	In the 'basic' scenario described, a holder of a 'Class A' share will have the right to demand cash at the earlier of: • The date of an acquisition • A fixed redemption date if no acquisition occurs beforehand In this case, the definition of a liability is met until the point at which the redemption feature lapses (resulting in derecognition of the expired liability). The classification of an instrument is, however, highly dependent on its specific features and the effect of any variation from the terms described here should be considered carefully to ascertain whether there is any action the company (as distinct from the holders of 'Class A' shares in their capacity as shareholders) can take to avoid redemption of its 'Class A' shares. If redemption might be through liquidation of the company, it is important to determine whether that is certain to occur unless an acquisition is completed and is outside the control of the company (such that the SPAC might be considered a limited life entity).
Warrants over 'Class A' shares	IPO or purchased separately by management team or sponsor	Give the holder the right to purchase 'Class A' shares at a set price. A number of structures can permit the holder to elect net share settlement of the warrant upon exercise (or permit such an election upon certain conditions).	If, as discussed above, the 'Class A' shares themselves are classified as liabilities until completion of an acquisition, it is first necessary to consider when the warrants become exercisable. If the warrants can be exercised while the 'Class A' shares are classified as liabilities, the warrants must also be so classified (as a derivative over a liability instrument cannot be equity). If, however, the warrants can only be exercised after an acquisition (or if the terms of the 'Class A' shares result in their classification as equity from inception), then the requirements of IAS 32 on derivatives over own equity apply. Applying these requirements, warrants to deliver equity shares are classified as equity if, and only if, they: • will be 'gross physically settled' via delivery of cash in return for shares (i.e. the terms of the instrument do not permit net share or net cash settlement); and • the amount of cash to be received and number of shares to be delivered in respect of each warrant is fixed in the functional currency of the issuer. If these conditions are not met, the warrants will be classified as derivatives and measured at fair value through profit or loss.

It is not appropriate to assume that the shares and warrants will always be accounted for applying IFRS 9 *Financial Instruments* and IAS 32 *Financial Instruments: Presentation*. When shares or warrants are issued to the sponsor, management team or other employees or service providers, consideration may be required as to whether the instruments were granted in return for services provided and, therefore, should instead be accounted for applying IFRS 2 *Share-based Payment*.

Typically, the 'Class A' shares and warrants are issued together on IPO as a 'stapled' unit and may be traded together after that date. The 'Class B' shares and warrants issued to founders or management may also be issued as part of a single transaction. In such cases, it is necessary to consider whether the two instruments are separable (that is, whether they should be accounted for as two distinct instruments or as a single, combined contract) and, if so, how the proceeds received on issuance should be allocated between the two instruments. If a liability and equity instrument are issued together, then the liability is initially recognised at its fair value with the remainder of the consideration recognised as equity. If two liabilities are issued simultaneously, an allocation of the proceeds in accordance with IFRS 9 is required. Incremental transaction costs of issuing equity instruments or debt instruments not at fair value through profit or loss should also be deducted from the initial carrying amount of the instrument as required by IAS 32 and IFRS 9 respectively.

One significant transaction undertaken by a SPAC will, of course, be its IPO. Careful consideration is needed in assessing whether any costs associated with that process are incremental costs directly attributable to an equity transaction, and as such should be deducted from equity rather than recognised immediately in profit or loss and in ensuring that costs incurred at a similar time (for example, start-up costs when a SPAC is set up only a short time before its IPO) are not inappropriately treated as costs of raising capital.

The treatment of other costs incurred by a SPAC during this phase of its life should be assessed as necessary, however costs relating to a potential future acquisition (for example, during the search for a target company or negotiation with an identified target) are unlikely to qualify for capitalisation under IAS 38 *Intangible Assets*.

Accounting for investments in SPACs
Whilst this publication primarily addresses financial reporting by the SPAC itself, it should also be noted that a holder of SPAC shares or warrants will need to consider the guidance in IFRS 10 *Consolidated Financial Statements* to determine whether it has control over the SPAC (and so, unless the holder is an investment entity measuring its investments at fair value, the SPAC should be consolidated), whether its investment is in the scope of IAS 28 *Investments in Associates and Joint Ventures* and should be accounted for using the equity method or whether it should be accounted for as a financial asset under IFRS 9.

The acquisition of a target company
As the transaction that transforms the SPAC from a single entity with assets comprised largely of cash to the parent company of a potentially large and diverse operating group, the acquisition of a target company (sometimes also referred to as a 'merger' or 'de-SPACing') is clearly a highly significant event in the lifecycle of the SPAC and one whose financial reporting consequences should be considered carefully.

The primary consideration in this respect, and one which drives much of the resultant accounting, is **identifying the acquirer**. As for any business combination, IFRS 3 *Business Combinations* will require consideration of whether the accounting should follow the legal form of the transaction (i.e. that the SPAC has acquired the target company) or whether, in substance, the reverse has occurred. Only after this assessment has been made can other significant questions (for example, whether the acquiree meets the definition of a business) be answered.

IFRS 3 provides the following guidance on how to identify the acquirer:

- If the consideration for the transaction is primarily cash, usually the entity that transfers that cash is the acquirer.
- If the transaction is effected through an exchange of equity instruments, the acquirer is usually the entity that issues its equity instruments. However, in these circumstances other pertinent facts and circumstances should be considered, including:
  - The relative voting rights in the combined entity after the business combination
  - The existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest
  - The composition of the governing body and senior management of the combined entity
  - The terms of the exchange of equity interests (with the acquirer typically paying a premium to effect the acquisition)
- The relative sizes of the two entities should also be considered, with the acquirer usually being the significantly larger of the two.

Following conclusion of this assessment, it is then necessary to consider **whether the transaction should be accounted for as a business combination or an asset acquisition**. This assessment is based on whether the accounting acquiree meets the definition of a business (and the transaction is a business combination) or instead the accounting acquiree is a group of assets (and the transaction is an asset acquisition).

Taken together, these two questions result in the four possible accounting outcomes outlined below in the consolidated financial

statements following the acquisition of the target company.

<table>
<tr><th></th><th>SPAC identified as the accounting acquirer</th><th>Target company identified as the accounting acquirer</th></tr>
<tr><td>Accounting acquiree meets the definition of a business</td><td>Acquisition accounting applying IFRS 3. SPAC recognises the target company's identifiable assets and liabilities at fair value (subject to specific exceptions in IFRS 3) on the acquisition date, along with goodwill, if any.

Acquisition-related costs recognised as an expense as incurred unless incremental to the issuance of a debt or equity instrument.

Only the SPAC's balances and transactions included in comparative information.</td><td>[It should be noted that only in rare circumstances would a SPAC with assets consisting largely of cash and limited other activities meet the definition of a business].

Reverse acquisition accounting applying IFRS 3, resulting in:
• Continuation of the target company's financial statements with an adjustment to the accounting acquirer's legal capital to reflect the legal capital of the SPAC.
• Recognition of the SPAC's identifiable assets and liabilities at fair value (subject to specific exceptions in IFRS 3) on the acquisition date.
• Recognition of goodwill determined using a calculation of the fair value of the notional number of equity instruments that the target company would have had to issue to the SPAC to give the owners of the SPAC the same percentage ownership in the combined entity.
• Acquisition-related costs recognised as an expense as incurred unless incremental to the issuance of a debt or equity instrument.

IFRS 3 also requires that the pre-combination equity structure be presented as that of the legal subsidiary (the target company), but adjusted retrospectively using the exchange ratio established in the acquisition agreement to reflect the number of shares of the legal parent (the SPAC) issued in the reverse acquisition.</td></tr>
<tr><td>Accounting acquiree does not meet the definition of a business</td><td>Cost of the acquisition allocated to identifiable assets and liabilities of the target company on a relative fair value basis.

No goodwill recognised and only the SPAC's balances and transactions included in comparative information.</td><td>[This scenario is relatively common for SPAC transactions – how such an outcome can affect financial reporting following that transaction is discussed further below].

Although not a reverse acquisition as defined in IFRS 3, the transaction might be characterised as a 'capital restructuring' or 'reverse asset acquisition' by the target company.

This treatment results in consolidated financial statements that are similar to those produced under reverse acquisition accounting except that:
• No goodwill arises.
• The requirement of IFRS 3 (for reverse acquisitions) to retrospectively adjust the legal subsidiary's equity structure does not directly apply. A suitable accounting policy should be developed to determine whether such a restatement of the equity structure is made and, if so, how it is calculated.

The IFRS Interpretations Committee also considered a similar transaction, reporting the following conclusions in the March 2013 IFRIC Update:
• If an acquisition of a 'cash shell' is achieved through an exchange of equity instruments, it is a share-based payment transaction within the scope of IFRS 2.
• On the basis of the guidance in IFRS 2 on unidentifiable goods and services, any difference between the fair value of the shares deemed to have been issued by the accounting acquirer [target company] and the fair value of the accounting acquiree's [SPAC's] identifiable net assets represents a service received by the accounting acquirer [target company].
• Regardless of the level of monetary or non-monetary assets owned by the non-listed operating entity, the entire difference should be considered to be payment for a service of a stock exchange listing for its shares, and no amount should be considered a cost of raising capital.</td></tr>
</table>

It should also be noted that, although achieving listed company status for the target company may be one of the main drivers of a SPAC transaction, this status does not constitute an identifiable asset as defined in IAS 38. As such, if the target company is identified as the accounting acquirer it should not recognise such an asset with any premium paid to attain listed status either subsumed within goodwill (if the SPAC meets the definition of a business) or recognised as an expense at the date of the transaction (if it does not).

Following acquisition of a target company

Following acquisition of the target company, the group headed by the SPAC will in many senses be a 'normal' publicly quoted group. However, as well as any financial reporting issues arising from the target's own operations, there may be issues arising from the history of the SPAC that continue to affect the group's reporting after the acquisition. For example:

- As part of the acquisition of the target company, the SPAC might issue 'earn-out' arrangements under which additional shares are issued to the SPAC's sponsors and/or the target company's shareholders upon the occurrence of certain events (for example, the combined entity's market capitalisation exceeding a target value).

- SPAC management might continue to work for the combined entity and to earn rights under share-based payment awards granted before the acquisition.

- Share-based payment awards previously granted to employees of the target company might be amended to give rights over SPAC shares (now the top company in the group) instead of over target company shares, modified in some other way or cancelled.

The accounting for such arrangements can be significantly influenced by the characterisation of the acquisition discussed above (i.e. the determination of the accounting acquirer and whether the transaction is considered to be a business combination). However, in the common circumstance in which the target company is considered to be the accounting acquirer and the SPAC is not considered to meet the definition of a business (accounted for, as discussed above, as a 'capital restructuring' or 'reverse asset acquisition'):

- 'Earn-out' arrangements of the type described above are subject to the requirements of IAS 32 on derivatives over own equity, often resulting in recognition of a liability to be measured at fair value, unless they are issued in return for service in which case the requirements of IFRS 2 apply.

- Share-based payment awards to SPAC management continuing to work for the combined entity will be accounted for under IFRS 2 (as they were by the SPAC prior to the acquisition). However, if the target company is identified as the accounting acquirer then the consolidated financial statements will not include any previous accounting for those awards. As a result, calculation of a 'fresh' grant date fair value might be required unless the target company has previously been party to the arrangement.

- Any modifications to or cancellations of existing share-based payment arrangements of the target company will need to be assessed under IFRS 2.

The requirements of IFRS Standards applicable only to listed entities (namely, IFRS 8 *Operating Segments* and IAS 33 *Earnings per Share*) will apply to the consolidated financial statements. For the SPAC, this will have been the case since its IPO (although as largely a cash shell, the resultant disclosures may have been limited). For the target company, these requirements may need to be applied for the first time. Again, in a circumstance where the target company is considered to be the accounting acquirer, it should be noted that:

- These requirements will apply retrospectively (e.g. comparative information on the group's operating segments will be required).

- The calculation of earnings per share will need to be retrospectively adjusted for events that have changed the number of shares outstanding without a corresponding change in resources. A change from the target company's previous share structure to the share structure of the SPAC at the date of acquisition could be such a change.

What other issues should be considered?

Although outside the scope of this publication, there are several other issues that may be relevant for companies considering a SPAC transaction, including:

- The requirements of the exchange upon which the SPAC is listed. Capital markets in different jurisdictions have different requirements in respect of SPACs, with some restricting the use of this mechanism and others having specific requirements for target companies to fulfil to ensure that investors have access to suitable information and that the target company will meet the obligations required of listed entities in that market. The exchange might also specify the financial reporting framework under which the company reports, which may differ from the framework which the target company previously applied.

- Public company readiness. As well as addressing the financial reporting specifics outlined above, a target company will have to be prepared for the obligations that come with public company status (for example, corporate governance and internal control requirements, enhanced requirements on auditor independence, investor relations and ongoing corporate reporting requirements). As a SPAC transaction can be agreed and completed relatively quickly, the timescale for this exercise could be restricted compared to a traditional IPO process.

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