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TOP SPAC MARKET ISSUES AND HOW TO ADDRESS THEM

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2021: THE YEAR OF THE SPAC SHAKE-UP

SPACs were all the rage in 2020, and that frenzy continued at an even more accelerated rate in Q1 of 2021. However, starting in mid-2021, headwinds to the SPAC market began to form. And whether these headwinds took the form of increased regulatory scrutiny, accounting issues, or just general softening of the willingness of investors to continue to invest in current deals, all of these factors lead to a decrease in activity that has persisted throughout the remainder of 2021. Increased regulatory scrutiny, accounting concerns and emerging trends have all contributed to disruptions in deal flow, restatements, delays in filings and other challenges.

In April 2021, the SEC issued **guidance** on warrant accounting, which caused nearly three-quarters of active SPACs to revise or restate their previously issued financial statements. After the April SEC guidance was largely dealt with and the landscape began to level out, the other shoe dropped in November as SPACs were once again dealing with accounting restatements. This time the restatements were triggered by the change in presentation of all Class A shares outside of permanent equity — another divergence from a long-standing SPAC practice.

Digging deeper into today's SPAC market issues and their implications opens the door for important conversations on how to ensure compliance with current practices and how to address challenges that may arise in the future.

ANCHORS AWEIGH – TRANSFERRING FOUNDER SHARES TO ANCHOR INVESTORS

During the SPAC market's mid-2021 cooldown, sponsors cranked their creativity into high gear, trying to carve out different avenues for SPAC success. Founder shares — considered Class B common shares issued to the sponsor — were commonly given to anchor investors. Anchor investors are typically institutional investors who make early commitments to buy a substantial amount of shares in the company before the IPO of a SPAC. Along with early access, anchor investors also tend to receive more favorable deal terms. This tactic had long been utilized in the SPAC market but surfaced as a more regularly occurring practice in August 2021.

Given that founder shares convert into Class A shares upon a successful de-SPAC transaction and are typically issued for nominal value when compared to the Class A shares offered in the IPO, additional issues can arise. For example, the anchor investor is likely receiving additional value over the price paid for the founder shares. Consequently, organizations must analyze this transaction for accounting purposes to determine if there are any accounting impacts to the financial statements of the SPAC. Generally, when a SPAC issues founder shares to anchor investors, the shares need to be fair valued, which is typically performed by a reputable valuation expert. The valuation will consider the lack of marketability of the shares until a de-SPAC is executed, as well as the probability that the SPAC will not be successful in locating and merging with a target company. In most instances, the fair value of shares is recognized as compensation cost. Also, because the fair value of the shares is likely greater than the price paid for the shares, any amount in excess of the fair value over the purchase price of the founder shares is generally regarded as offering cost.

The sale of founder's shares is just one lever sponsors have utilized to generate interest in a SPAC, but this lever does not come without specific accounting and reporting implications. This reality, coupled with the change in economics to the sponsor, may mean the sale of founder shares is not the best course of action. Some SPACs and their sponsors have looked to other options such as paid extensions to prolong the life of the SPAC. Under this approach, a sponsor will agree to pay to extend the life of the SPAC in three-to-six month increments to account for the possible delay in completing the merger and possible filing delays. Any monies paid for possible extensions would be deposited into the trust account and would then be refunded to the Class A shareholders if a transaction never occurred.

While these extension options may introduce some complexities, this approach seems to hold some level of attractiveness to potential investors. It's possible this trend will continue for the foreseeable future, thanks to its effectiveness in creating and retaining interest in the SPAC entities themselves.

PERMANENT OR TEMPORARY? CHANGE IN CLASSIFICATION OF CLASS A SHARES

As the popularity of SPACs persists, accounting and reporting considerations continue to be a major area of focus for regulators. Upon completion of its IPO, a SPAC will typically issue equity shares that are redeemable at the option of the holder or an event that is outside the control of the SPAC. These redeemable shares are often referred to as Class A common shares.

Historically, many SPACs accounted for the majority of the Class A shares as mezzanine, or temporary, equity under ASC 480, and presented them outside of permanent equity on the issuer's balance sheet. However, the SPAC also included a small number of Class A shares within permanent equity. The basis for this historical presentation lies in restrictive covenants within the SPAC's article of incorporation as well as specific listing requirements. This presentation required a calculation to classify just enough redeemable Class A shares in permanent equity to keep the issuer's equity balance above a threshold amount. Generally, the threshold was $5,000,001, with the remaining redeemable shares being classified in mezzanine equity.

The view that the $5,000,001 requirement for permanent equity had to be maintained in order to qualify for an exemption to the penny stock rules, as well as minimum exchange listing requirements, was widely accepted. However, U.S. GAAP dictates that an instrument that is redeemable at the option of the holder, or outside the control of the company, should be classified outside of permanent equity. Given the prescribed accounting treatment in U.S. GAAP, it was determined that the entirety of the Class A shares would have to be classified and presented within mezzanine equity.

Consequently, in September 2021, after informal communications with the SEC, SPACs concluded that all redeemable shares should be presented outside of permanent equity. In addition, not only were there classification and presentation considerations; but with the change, ASC 480 also prescribes subsequent measurement guidance ("Day 2 Accounting") for any instrument classified outside of permanent equity. Those and the reporting impacts also required consideration. Therefore, recording Class A shares in permanent equity would be inconsistent with the guidance within U.S. GAAP, including the effects of subsequent measurement for these instruments. As a result, nearly all SPACs were faced with the reality of previously issued financial statements where material misstatements likely existed, and restatements were required to align the historical presentation to follow U.S. GAAP.

Now that the accounting treatment has been largely settled, SPACs must work with their auditors and accounting advisors to determine the best path forward. For SPACs that have not yet filed an effective registration statement, the next steps should be relatively straightforward as management should ensure the pro forma calculations and tables present all of the redeemable shares as mezzanine equity. For SPACs that have filed historical financial statements, it is encouraged that those SPACs discuss the appropriate path forward with their advisors and auditors.

WHAT'S NEXT FOR SPACS?

It's likely many of the accounting and reporting changes for SPACs that surfaced throughout 2021 will lead to more alignment between SPAC entities and those of traditional operating companies. Any restatements will have likely worked through the system by the end of 2021 and should provide little resistance or headwinds to a reinvigorated volume of SPACs in 2022.

The regulatory front is still evolving. Based on **recent statements** by SEC Chairman Gary Gensler, there will continue to be changes in the way SPACs are viewed from a regulatory perspective to more closely align the SPAC IPO process with that of a traditional IPO. It seems possible that Gensler's plans for new rulemaking and interpretations for SPACs might be to better align their requirements more closely to those of a traditional IPO – particularly in the areas of projections, conflicts of interest and relevant disclosures to ensure the continued protection of investors. Whether these changes further cool the SPAC market or provide greater clarity and consistency — therefore paving the way for investors to plunge back into the market — remains to be seen.

For SPAC sponsors and individual shareholders, the long-term impacts of SPACs in the broader marketplace are still unknown. All parties involved should continue to be mindful of broader market conditions and possible regulatory changes. Overall, the recent uptick in SPAC activity underscores that this investment vehicle may have real staying power.

Thinking about becoming a SPAC sponsor, but running into issues? Visit **BDO's SPAC page** for a list of services and reach out to **BDO's Accounting & Reporting Advisory Services practice group** for more information.

Thinking of pursuing a SPAC transaction, but running into hurdles?

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