Accounting and Transaction Advisory Services (ATS)

Considerations Related to SPAC Transactions

BACKGROUND

As a firm, we find that we are being asked more and more about the benefits of merging with a SPAC versus a traditional IPO. A SPAC, or special purpose acquisition company, is a "blank-check" company that completes an initial public offering (IPO) with the intent of using the funds to acquire an existing operating company (or companies) – usually a private company. SPACs have been around for decades but have increased in popularity in recent years due to more high-profile SPAC transactions and support from high-quality sponsors and investment banks.

We find that SPAC transactions can often provide private operating companies with an alternative, and often accelerated, path to becoming a public company. However, this alternative path usually requires an equivalent level of effort, and it presents different accounting and financial reporting challenges.

LIFECYCLE OF SPACS

A SPAC is typically formed with nominal capital by a group of experienced investors and managers known as "sponsors." The SPAC then files a registration statement on Form S-1 with the Securities and Exchange Commission (SEC) to conduct its IPO and raise additional capital. The IPO process for a SPAC is often accelerated because the registration statement is less complex than that of an operating company going public. The registration statement will generally include a seed balance sheet of the SPAC, information about the legal formation of the SPAC, and its plans to acquire one or more operating companies, usually in a specific geographic region and/or industry.

Equity issued in a SPAC IPO typically takes the form of a unit, consisting of one share of common stock and one warrant to purchase half a share of common stock. The warrant is typically issued out of the money at the time of the IPO and is designed to compensate the holders for making an initial investment prior to the acquisition of an operating company. The proceeds from the SPAC IPO are placed in a trust account until they are needed to purchase an operating company.

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LIFECYCLE OF SPACS CONT'D

When the SPAC identifies an operating company to acquire (often a private company), the SPAC must obtain approval from the public shareholders to consummate the transaction. At this time, the public shareholders have the right to redeem their common shares if they do not want to invest in the combined company (the warrants usually remain outstanding even if the common shares are redeemed). The public shareholders' decision to redeem their shares is separate from the vote to approve the transaction. This redemption feature can create some uncertainty for the private operating company over how much cash will be left in the combined company after the transaction.

A SPAC generally has between 18 to 24 months to consummate the acquisition of an operating company based on its formation documents. This time period can be extended with shareholder approval. Otherwise, the funds held in trust must be returned to investors if an acquisition is not consummated during this timeframe.

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FINANCIAL REPORTING CONSIDERATIONS

The first step in determining the accounting and financial reporting implications of a SPAC transaction is to determine which entity is the "accounting acquirer." The accounting acquirer is generally the entity that has taken control over another entity. The accounting acquirer can be different from the legal acquirer, which is generally the issuer of equity interests. Transactions in which the legal acquirer is not considered to be the accounting acquirer are referred to as "reverse mergers." If a SPAC acquires an operating company for all cash consideration, it is usually considered to be the accounting acquirer. If the consideration transferred is a mix of cash and equity, the analysis can be more complex. In recent years, many SPAC transactions have been structured such that the cash stays in the SPAC and equity interests in the SPAC are issued instead such that the acquired operating company eventually takes control over the SPAC. In this fact pattern, the operating company would be considered the accounting acquirer (even though the SPAC is the legal acquirer).

If a SPAC transaction is treated as a reverse merger, a determination must be made as to whether the SPAC meets the definition of a "shell company" under Rule 12b-2 of the Exchange Act and Rule 405 of Regulation C. If so, the SEC Staff will consider the transaction to be, in substance, a capital transaction, rather than a business combination. These so called "reverse recapitalizations" are equivalent to the issuance of stock by the private operating company for the net monetary assets of the shell company, accompanied by a recapitalization. The accounting for a reverse recapitalization is similar to a reverse acquisition, except that there is no change in basis (purchase accounting) for the assets and liabilities of the accounting acquiree. As discussed further below, there are, however, significant financial reporting differences between reverse acquisitions and reverse recapitalizations.

BEFORE CLOSING A REVERSE MERGER

If a reverse merger with a SPAC is consummated by the issuance of registered equity securities, those shares will be registered by filing a Form S-4 with the SEC. The consummation of the merger and issuance of new securities will require approval from the public shareholders. As such, the proxy statement for the shareholder vote is often combined with the registration statement on a joint Form S-4/proxy statement.

The financial reporting on Form S-4 follows the legal form of the transaction. Even though the private operating company may be considered as the accounting acquirer, it is considered as the "target" company for the purposes of the Form S-4. The historical financial statements of the target are those that would be required in the target's annual report (if they were required to file an annual report as a public registrant). The target may apply scaled disclosures if they qualify as a smaller reporting company (SRC), irrespective of whether the issuer/legal acquirer qualifies as an SRC.

The financial statements of the target need to be reported in accordance with GAAP for public business entities (PBEs) or IFRS if applicable, and Regulation S-X. Generally, the financial statements of a target company reported in a Form S-4 are afforded accommodations similar to those of an acquired company under Rule 3-05. That is, the SEC Staff will permit the adoption of ASC 606 and ASC 842 under the prescribed private company transition guidelines. However, in a reverse recapitalization, all accounting standards should be adopted by the target under the prescribed public business entity (PBE) guidelines. Additionally, the financial statements of the target company in a reverse recapitalization must be audited under PCAOB standards.

AFTER CLOSING A REVERSE MERGER

After closing a reverse merger with a SPAC, the private operating company (the accounting acquirer) becomes the predecessor and the legal successor to the issuer's reporting obligations under the Exchange Act. The historical financial statements of the registrant become those of the private operating company as the predecessor. The determination of the predecessor entity may be more complex in situations where the SPAC acquires multiple operating companies.

Within 4 business days of the closing of the reverse merger, the combined company will be required to file a Form 8-K (Item 2.01) reporting the closing of the acquisition. This Form 8-K must include all of the content required to be included in a Form 10 for the private operating company, and there is no grace period permitted. In a reverse recapitalization, the determination of whether the private operating company can apply scaled disclosures applicable to SRCs depends on whether it qualifies as an SRC. However, in a reverse acquisition, this determination is based on whether the legal acquirer (*not the accounting acquirer*) qualifies as an SRC. This distinction is important because there could be situations in which scaled disclosures are permitted in the historical financial statements of the private operating company in the Form S-4 but are not permitted in Exchange Act filings after the closing.

ICFR CONSIDERATIONS

In a reverse acquisition, management's report on internal controls over financial reporting (ICFR) may be required in the annual report on Form 10-K following the closing of the merger, as legally the entity is not considered to be a "newly public company." However, the reporting entity may be able to apply FAQ 3 to the internal controls over financial reporting of the private operating company, as a recently acquired business, and exclude it from its annual assessment for up to 12 months following the date of the acquisition. Following a reverse recapitalization, the reporting entity generally gets a pass on reporting on ICFR until the second 10-K following the merger (based on SEC interpretive guidance).