Snapshot

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SEC staff addresses warrants issued by SPACs

The SEC staff recently issued a statement discussing certain accounting and reporting considerations related to warrants issued by special purpose acquisition companies (SPACs). The statement addresses whether warrants issued by a SPAC should be classified as equity or a liability, as well as financial reporting considerations if a registrant determines there is an error in any previously filed financial statements related to the classification of these warrants.

Accounting considerations

Generally, warrants issued by a SPAC remain outstanding for five years after the date on which the SPAC completes its initial business combination. Accordingly, the financial reporting considerations in the statement also apply to reporting entities that have merged with a SPAC as long as the warrants remain outstanding. The statement discusses the application of the indexation and equity classification guidance in ASC 815-40, *Derivatives and Hedging: Contracts in Entity's Own Equity,* to certain terms commonly seen in warrants issued by SPACs.

Under ASC 815-40, an entity must classify a freestanding financial instrument (such as a warrant) within equity if both of the following conditions exist:

- The instrument's settlement amount is based on the difference between a fixed monetary amount and the fair value of a fixed number of the entity's shares (indexation criterion).
- The instrument would qualify for equity classification (the equity classification criterion).

Indexation guidance

ASC 815-40-15 provides guidance for determining whether a warrant's settlement amount is based on the difference between a fixed amount of consideration and the fair value of a fixed number of the entity's shares. Adjustments to the settlement amount do not preclude a warrant from being indexed to the entity's shares, provided that any variables that might adjust the settlement amount are inputs used in the pricing of a fixed-for-fixed forward or option on equity shares (such as inputs used under the Black-Scholes option pricing model). The guidance in ASC 815-40-15-7E includes a list of such inputs.

The SEC staff recently evaluated a fact pattern where the warrants issued by a SPAC included provisions that provided for potential changes to the settlement amounts dependent upon the characteristics of the holder of the warrant (for example, settlement amounts differed for warrants held by the SPAC's sponsor or its related parties compared to warrants held by public holders). The staff concluded that since the holder of the instrument is not an input into the pricing of a fixed-for-fixed option on equity shares, such a provision would preclude the warrants from being indexed to the entity's stock, and the warrants should be classified as a liability.

Equity classification guidance

ASC 815-40-25 provides guidance for determining whether a warrant would qualify for equity classification. In general, the guidance stipulates that a warrant does not qualify for equity classification if the issuer could be required to settle the warrant in cash, regardless of the likelihood that circumstances would arise requiring cash settlement. However, the guidance provides an exception where a warrant would not be precluded from equity classification if net cash settlement of the warrant is only required in circumstances when all holders of the equity shares underlying the warrant would also receive cash in exchange for their equity shares. Such circumstances might include a change in control or another deemed liquidation event, as described in ASC 815-40-55-2 through 55-5.

The SEC staff recently evaluated a fact pattern where the warrants issued by the SPAC included a provision stipulating that in the event of a tender or an exchange offer made to the equity shareholders (which could be outside the control of the SPAC) that is accepted by holders of more than 50 percent of the outstanding equity shares of a single class of common stock, all warrant holders would be entitled to receive cash for their warrants. In this fact pattern, the SEC staff concluded that the tender offer provision would require the warrants to be classified as a liability, since only certain of the holders of the equity shares underlying the warrants would be entitled to cash, whereas all warrant holders would be able to receive cash.

Other considerations

The staff statement reminds companies that evaluating accounting for contracts in an entity's own equity, such as warrants issued by a SPAC, requires careful consideration of the specific facts and circumstances. The items discussed above may not be the only features in a warrant agreement that require the warrants to be classified as a liability. Entities should consider each provision in the warrant arrangement to determine the appropriate classification of the warrant.

Reporting considerations

The statement alerts registrants and their independent auditors that, after reviewing the accounting considerations related to warrants, they need to evaluate whether there is an error in any previously filed financial statements. If an error is identified, registrants need to evaluate (1) the materiality of the error,[1] and (2) whether they are required to file a report under Item 4.02 of Form 8-K indicating that the previously filed financial statements impacted should not be relied upon and to restate those financial statements.

When a material financial statement error is identified, registrants are generally required to amend reports previously filed under the Securities Exchange Act of 1934 (Exchange Act). However, because the warrant accounting errors could affect multiple Exchange Act filings, including previously filed quarterly and annual reports, the statement indicates that registrants may correct material errors related to the accounting issue by amending only their most recent Form 10-K and any subsequently filed Form 10-Qs. The staff indicated that the amended filings must include

- Restated financial statements and footnote disclosures required by ASC 250;
- Restated quarterly financial information in accordance with Item 302 of Regulation S-K; and
- Amendments to disclosures under Item 303 of Regulation S-K for each period presented, as necessary.

The statement reminds registrants to reassess whether prior assessments regarding the effectiveness of internal control over financial reporting and disclosure controls and procedures should be revised in the amended filings, as well as whether those controls are currently adequate. This assessment should not be limited to the actual error, but instead should consider the magnitude of the potential error. When applicable, registrants' auditors will need to evaluate managements' assessments.

Further, the statement includes guidance for registrants with pending submissions and filings. If such filings include warrant accounting errors but the errors are not deemed material, registrants may facilitate the processing of such pending submissions and filings by providing the staff of the Division of Corporation Finance with a written representation describing their situation in a correspondence on Edgar.

Lastly, registrants are reminded of their obligations related to the disclosure of material nonpublic information under Regulation FD.

[1] See Staff Accounting Bulletin (SAB) No. 99, (Topic 1.M, *Materiality*).

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