



Viewpoint

Merging with a special purpose acquisition company (SPAC)



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The content in this publication is based on information available as of March 30, 2021. We may update this publication for evolving views and as we continue to monitor the standard-setting process and implementation of any ASC amendment. For the latest version, please visit grantthornton.com.

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Introduction

Private companies are increasingly going public through an acquisition by a public special purpose acquisition company (SPAC), rather than through the traditional initial public offering (IPO) route. SPAC transactions can give rise to unique financial reporting and accounting issues. If a private operating company opts to be acquired by a SPAC, the SPAC will be required to include the operating company's financial and nonfinancial information in its filings with the Securities and Exchange Commission (SEC). The information required in those SEC filings is similar to what the operating company would have included in its own IPO registration statement.

This publication focuses on the information required in SEC filings for a private operating company being acquired by a SPAC. It also addresses certain key accounting considerations for the U.S. GAAP financial statements of the combined entity following a SPAC transaction.

A SPAC is a shell company formed for the purpose of acquiring an operating company and typically conducts its IPO shortly after its formation. The cash raised in the SPAC's IPO is held in a trust account and is ultimately used, often with additional equity securities of the SPAC, to purchase an operating company. Following its IPO, the SPAC must comply with SEC reporting requirements, including filing periodic reports on Forms 10-Q and 10-K, as well as current reports on Form 8-K.

The SPAC's governing documents usually specify a timeframe by which it must acquire an operating company, or it must be dissolved and return the capital to its investors. Some SPACs are formed with the intention of completing an acquisition in a particular industry, while others have more flexibility. SPAC shareholders typically have a redemption option whereby they can receive a distribution from the trust account rather than continue as owners in the post-merger publicly traded operating company. In order to have sufficient capital (after redemptions) to complete the acquisition of the operating company, the SPAC may obtain additional financing from its sponsor, or a committed debt or equity financing, often referred to as private investment in public equity (PIPE).

Once the SPAC identifies an operating company target, the acquisition is usually subject to approval by the SPAC's shareholders. Accordingly, to solicit shareholder approval, the SPAC will either file a proxy on Schedule 14A or, if the purchase consideration includes registered securities of the SPAC, a combined proxy and registration statement on Form S-4 (collectively referred to as Form S-4/merger proxy). The staff of the SEC's Division of Corporation Finance (CorpFin) reviews the Form S-4/merger proxy with the same level of rigor as an IPO registration statement. Upon completion of SEC staff review, the Form S-4/merger proxy is distributed to the SPAC's shareholders for their vote to approve the merger and other related administrative proposals, such as the election of directors or approval of an equity compensation plan.

Once the merger is completed, the registrant has four business days to file a current report on Form 8-K, referred to as the "Super 8-K," which includes, among other things, all information that would be required if the registrant were filing a registration statement on Form 10. Further, SPAC transactions are typically accounted for as reverse mergers, whereby the private operating company's financial statements become the historical financial statements of the registrant, and the combined entity must comply with ongoing SEC reporting obligations, including filing current and periodic reports.

1. Form S-4/merger proxy statement requirements

1.1 Information required for the SPAC

In the Form S-4/merger proxy, the SPAC must comply with the requirements applicable to the registrant. For example, the SPAC should include or, when appropriate, incorporate by reference its historical financial statements and other information, such as a description of the business and Management's Discussion and Analysis (MD&A), as required by the form. Much of this information is already included in the SPAC's IPO registration statement and subsequent periodic reports.

SPACs should also consider the SEC staff guidance in CF Disclosure Guidance [Topic No. 11, *Special Purpose Acquisition Companies*](#), which highlights the importance of clear disclosures regarding potential conflicts of interest,¹ as well as the nature of the economic interests in the SPAC held by its sponsors, directors, officers, and affiliates. Disclosure topics specific to business combination transactions by a SPAC include additional financing needed to complete the transaction; the evaluation of potential transactions and how the target was selected; conflicts of interest, including how the conflict was managed; and compensation to service providers contingent on the business combination.

1.2 Information required for the operating company target

Given that the SPAC has limited operating activity, upon acquisition, the operating company will be the predecessor² to the registrant. This is true even if the operating company is not the acquirer for accounting purposes. Therefore, in general, the disclosures required of the operating company target are consistent with those that would be required in a registration statement if the operating company were conducting its own IPO.

SPAC mergers involving multiple operating companies require careful evaluation of the facts and circumstances to identify the predecessor, as additional requirements apply to the predecessor compared with the other operating companies. Items to consider in making that determination include the order in which the entities are acquired, the size and fair value of the entities involved, the ongoing management structure, and which entity is the accounting acquirer in the transaction. None of these factors is individually determinative, and it is possible that an entity may have more than one predecessor. Whether

¹ The guidance explains that conflicts of interest may arise since a SPAC's sponsors, directors, and officers may also have fiduciary or contractual obligations to other entities and may not be working exclusively on behalf of the SPAC to identify acquisition targets.

² The term "predecessor" is broadly defined in Securities Act Rule 405 and Exchange Act Rule 12b-2 as "a person the major portion of the business and assets of which another person acquired in a single succession, or in a series of related successions in each of which the acquiring person acquired the major portion of the business and assets of the acquired person." CorpFin's Financial Reporting Manual (FRM) states that for purposes of financial statements, designation of an acquired business as a predecessor is generally not required except where a registrant succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities) and the registrant's own operations before the succession appear insignificant relative to the operations assumed or acquired.

or not the entity is the predecessor will determine the level of information that is required in the Form S-4/merger proxy and Super 8-K, as well as the standards under which the financial statements must be audited. This publication assumes that there is only one operating company target that will be acquired by the SPAC.

1.2.1 Financial statement requirements

The SEC staff expects the operating company's financial statements to be presented as if it was the operating company's initial registration statement. Such financial statements must comply with Regulation S-X requirements; include public company U.S. GAAP disclosures, such as segments and earnings per share (EPS); and comply with the requirements applicable to public business entities, which prohibit the use of the FASB's Private Company Council accounting alternatives. The SEC staff also expects annual financial statements of the operating company to be audited in accordance with PCAOB standards. In addition, the operating company must evaluate whether separate financial statements are required for certain other entities, such as acquired or to be acquired businesses, as well as equity method investees.

Interim financial statements of the operating company target should comply with Regulation S-X, Article 10, *Interim financial statements*, which requires current-year and comparative prior year-to-date statements of operations, cash flows, and changes in shareholders' equity. In addition, such interim financial statements should comply with ASC 270, *Interim Reporting*.

Number of periods

The Form S-4/merger proxy ordinarily requires financial statements for the target for the three most recent fiscal years, and comparative year-to-date interim financial statements as needed to comply with the age requirements under Regulation S-X. However, only two years of audited financial statements for the operating company would be required if either

- Both the SPAC and the operating company qualify as an emerging growth company (EGC),³ and the SPAC has not filed and is not yet required to file its first Form 10-K; or
- The operating company qualifies as a smaller reporting company (SRC).⁴

Age of financial statements

Financial statements of the operating company included in a Form S-4/merger proxy must be as of a date no earlier than 134 days (or 129 days if the SPAC is an accelerated or large accelerated filer) before the filing; however, third-quarter financial statements comply with the age requirements through 45 days after the most recent fiscal year-end of the operating company. Age requirements must be met both at the time of filing the Form S-4/merger proxy as well as at effectiveness of Form S-4 or the mailing of the proxy statement, as applicable.⁵ Accordingly, if the Form S-4/merger proxy is filed 45 days after the operating

³ As defined in Securities Act Rule 405. Also, see FRM Section 10110 for more information on eligibility. EGC status is a legal determination. An operating company target would generally qualify to be an EGC if its annual revenues during the most recently completed fiscal year are less than \$1.07 billion and it has issued less than \$1 billion in nonconvertible debt securities in the preceding three years.

⁴ As defined in Regulation S-K, Item 10(f)(1). SRC status is a legal determination. An operating company target that has less than \$100 million in annual revenues for its most recently completed fiscal year would generally be eligible to be an SRC.

⁵ See FRM Sections 1220.7 and 1220.8.

company's fiscal year-end, the company's audited annual financial statements for the most recently completed fiscal year will ordinarily be required in the filing.

Financial statements of other entities

The operating company should also evaluate whether it is required to provide the financial statements or the summarized financial information of other entities, such as significant probable and recently completed business acquisitions under S-X Rule 3-05, or significant equity method investees under S-X Rules 3-09 and 4-08(g). The definition of a business under S-X Rule 11-01 is different from the definition of a business under ASC 805, *Business Combinations*. Accordingly, an acquisition accounted for as an asset acquisition under U.S. GAAP could be an acquisition of a business under SEC reporting rules. In that case, audited pre-acquisition financial statements of the operating company's acquiree may be required, regardless of the U.S. GAAP accounting for the transaction.

In 2020, the SEC amended S-X Rule 3-05, S-X Article 11, *Pro forma financial information*, and S-X Rule 1-02(w), which describes the tests used to measure the significance of acquired or to-be-acquired businesses and equity method investees. For more information on these amendments, refer to Grant Thornton's [New Developments Summary \(NDS\) 2020-09, "SEC amends financial disclosures for business acquisitions and dispositions."](#)

Audit and review considerations

The SEC staff expects the annual financial statements of the private operating company that will be the predecessor to the registrant to be audited in accordance with PCAOB standards.⁶ While the operating company's interim financial statements included in the Form S-4/merger proxy are not required to be reviewed, independent auditors are generally engaged to review such financial statements.

Annual financial statements of other entities, such as significant acquirees or equity method investees⁷ or other acquirees of the SPAC that are not determined to be a predecessor, may be audited under AICPA standards.

Adoption of new accounting standards

In general, an EGC may elect to defer compliance with new or revised financial accounting standards until a company that is not an issuer⁸ is required to comply with such standards. The SEC staff has clarified that in a reverse merger with a SPAC, the operating company target may also follow nonissuer accounting standard adoption dates, provided that all of the following conditions are met:

⁶ See FRM Sections 1140.5, 2200.7, and 4110.5. The private company will not meet the definition of an "issuer" whose audit is under the jurisdiction of the PCAOB. Accordingly, the auditor must conduct an audit in accordance with AICPA standards and issue a dual reference report. These requirements also apply to the financial statements included in Form 8-K filed upon consummation of the acquisition.

⁷ If the principal auditor of the operating company makes reference to the equity method investee's audit report, then PCAOB standards must be used in the audit of the equity method investee.

⁸ The term "issuer" means an issuer (as defined in Section 3 of the Exchange Act), the securities of which are registered under Section 12 of the Exchange Act, or that is required to file reports under Section 15(d) of the Exchange Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act, and that it has not withdrawn.

- The SPAC registrant is an EGC that has elected to use the extended transition period for complying with any new or revised financial accounting standard.
- The operating company target whose financial statements are included in the SPAC's Form S-4/merger proxy also qualifies as an EGC.
- The post-merger entity would qualify as an EGC.^{9 10}

1.2.2 Pro forma financial information

In the Form S-4/merger proxy, the registrant is required to include pro forma financial information giving effect to the merger and any other material transactions.¹¹ Such information should be prepared in accordance with S-X Article 11 and should distinguish between the transaction being voted upon and other transactions.

Ordinarily, the Form S-4/merger proxy includes a pro forma condensed combined balance sheet as of the end of the most recent period for which a consolidated balance sheet of the registrant is required, as well as pro forma condensed combined statements of comprehensive income for the registrant's most recent fiscal year and the subsequent year-to-date interim period.

When preparing pro forma financial information to give effect to a SPAC merger transaction, questions frequently arise in the following areas:

- *Accounting acquirer determination:* Pro forma financial information is required to reflect the accounting for the merger transaction. Accordingly, determining the accounting acquirer is an important step. For guidance on considerations related to such determination, refer to Section 3.1, "Determining the accounting acquirer in ASC 805."
- *Range of possible redemptions by SPAC investors:* In a SPAC merger transaction, a number of existing shareholders in the SPAC may choose to redeem their ownership interest rather than continue as owners in the post-merger entity. To minimize the risk of the transaction failing due to excessive redemptions, the SPAC may secure potential additional financing and/or establish potential modified transaction terms with the target. When the transaction is structured so that significantly different results may occur, S-X Rule 11-02(a)(10) requires additional pro forma presentations to give effect to a range of possible results. Since the actual redemptions are unknown at the time of the preparation of the Form S-4/merger proxy, the pro forma financial information ordinarily reflects both a "no redemption" scenario and a "maximum redemption" scenario beyond which the transaction will not be consummated, as well as any contemplated additional financing.

⁹ See the [July 2020 CAQ SEC Regulations Committee Highlights](#), Section III, "Current financial reporting matters," under "B. Financial statement requirements in an S-4 and/or merger proxy for a non-reporting target merging with a public operating company, shell company or SPAC in a reverse merger."

¹⁰ See FRM Section 10120.2 for guidance on determining EGC status after a merger transaction.

¹¹ Pro forma financial information is required under Item 11 of Schedule 14A and Item 5 of Form S-4.



Grant Thornton insights: Effect of redemptions on accounting acquirer conclusion

As the number of redemptions increases, the SPAC shareholders' ownership in the post-merger combined entity will decline. As discussed in Section 3.1, the level of ownership held by the SPAC's historical shareholders is among other factors considered in determining the accounting acquirer. Accordingly, it is possible that the SPAC may be the accounting acquirer under the "no redemption" scenario, while the operating company may become the accounting acquirer under the "maximum redemption" scenario. The pro forma financial information should be prepared to reflect the appropriate accounting in the each of these respective scenarios.

The pro forma financial information should also reflect the adjustments resulting from how the transaction is structured. For instance, the merger could result in an umbrella partnership C corporation (UP-C), which could require adjustments related to noncontrolling interests and tax receivable agreements. For more details on related accounting for transactions that use an UP-C structure, refer to Section 3.1.1, "Identifying the accounting acquirer in SPAC transactions."

1.2.3 Nonfinancial disclosure requirements

The operating company target must provide disclosures similar to those provided in an IPO registration statement. The requirements include, but are not limited to, the following:

- *Business*: Regulation S-K, Item 101, *Business*, requires a principles-based description of the company's business.
- *Risk factors*: Regulation S-K, Item 105, *Risk factors*, requires a discussion of the risk factors specific to the company that could make an investment in the company speculative.
- *MD&A*: Regulation S-K, Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, requires the company to discuss and analyze its business from management's perspective. MD&A includes a discussion and analysis of historical results for each annual and interim period presented, liquidity, and capital resources, as well as the trends and expectations for future financial results. Companies should include an analysis of the risks and uncertainties that could materially impact the business, a discussion of off-balance-sheet arrangements, and critical accounting estimates, among other items.
- *Change in accountants*: The Form S-4/merger proxy requires disclosures under Regulation S-K, Item 304, *Changes in and disagreements with accountants on accounting and financial disclosure*, for the operating company. However, the disclosure requirement is limited to only disagreements or reportable events required under S-K Item 304(b).
- *Internal control over financial reporting (ICFR)*: While a private company operating target is not required to provide management's report on disclosure controls and procedures (DCP) or ICFR under Regulation S-K, Items 307 or 308, respectively, the existence of one or more material weaknesses in ICFR at the operating company target is ordinarily considered material information that should be disclosed in the Form S-4/merger proxy. Similar to existing practice for companies in the process of an IPO, any material weaknesses are ordinarily disclosed in the Form S-4/merger proxy within the risk factors section and/or within MD&A.

2. Post-merger reporting

2.1 Super 8-K

Overview

No later than four business days after the SPAC registrant completes its acquisition of the operating company target, it must file a Form 8-K, often referred to as the “Super 8-K,” including disclosures under

- Item 2.01, “Completion of acquisition or disposition of assets”
- Item 4.01, “Changes in registrant’s certifying accountant”
- Item 5.01, “Changes in control of registrant”
- Item 5.06, “Change in shell company status”
- Item 9.01, “Financial statements and exhibits”

Depending on the facts and circumstances, additional disclosure items may be required in the Super 8-K. The 71-day extension available to file the historical financial statements of a significant business acquisition under S-X Rule 3-05 and related pro forma financial information under S-X Article 11 is not available for acquisitions by shell companies.¹²

Financial statements and related disclosures

For acquisitions consummated by a SPAC, Items 2.01 and 5.01 of Form 8-K require the same information with respect to the operating company that would be required in a registration statement on Form 10. Much of the information required in the Super 8-K was already included in the previously filed Form S-4/merger proxy, and can be incorporated by reference into the Super 8-K. However, companies should consider if any information needs to be updated, including

- *Financial statements*: The financial statements of the operating company may need to be updated to meet the applicable age requirements at the time the Super 8-K is filed, and there can be no lapse in reporting for the operating company. Accordingly, if a more recent annual or quarterly reporting period ends prior to consummation of the merger and the financial statements for such period are neither included nor required to be included in the Super 8-K to meet the applicable age requirements, the registrant must amend the Super 8-K at a later date to include such financial statements. If an amendment is required in that circumstance, it would also include updated other information that is required in Form 10-K or Form 10-Q, as applicable, for the registrant and its predecessor, including MD&A. The amended Super 8-K must be filed within a certain number of days after the operating company’s period-end, based on the registrant’s filing status as shown in Figure 2.1.¹³

¹² See Form 8-K, Item 9.01(c).

¹³ See FRM Section 12220.1.c.

Figure 2.1 – Amended Super 8-K deadlines

Filing status of the registrant	Due date of amended Super 8-K after operating company's period-end	
	Interim period	Annual period
Large accelerated filer	40 days	60 days
Accelerated filer	40 days	75 days
Non-accelerated filer	45 days	90 days

- *Updated pro forma information:* While the Form S-4/merger proxy generally includes pro forma information giving effect to minimum and maximum redemption scenarios, once the merger is completed, the actual number of redemptions, as well as the amount and terms of any additional financing, will be known. If the actual redemptions, financing terms, or other information are materially different from the previously reported pro forma financial information, the pro forma information should be updated.

The SEC staff has provided interpretive guidance in [CF Disclosure Guidance Topic No. 1, Staff Observations in the Review of Forms 8-K Filed to Report Reverse Mergers and Similar Transactions](#). This guidance provides an overview of common areas of comment with respect to the Super 8-K.

Change in auditor disclosure

The Super 8-K generally includes disclosures under Item 4.01. The SEC staff's interpretive guidance¹⁴ indicates that the completion of a reverse merger always results in a change in accountant, unless the financial statements of both the registrant and the operating company were audited by the same audit firm. The Super 8-K should include disclosures required by S-K Item 304 treating the accountants that will no longer be associated with the registrant's financial statements as the predecessor accountant. Similar considerations apply to a forward merger where the SPAC is the accounting acquirer. The SEC staff has noted that if, as of the filing of the initial Form 8-K, a decision has not been made as to which accountant will continue as the registrant's auditor, an Item 4.01 Form 8-K must be filed within four business days following the decision date.

2.2 Determining filing and disclosure status after the merger

Questions often arise regarding the determination of filing status as well as SRC and EGC status following the merger of the SPAC and operating company target. Registrants should consult with their qualified securities counsel on these matters.

¹⁴ See FRM Section 4520, "Unusual Issues Involving Changes in Accountants," and Section 12230, "Change in Accountants."

Filing status

Ordinarily, filing status determines the due dates for periodic reports on Forms 10-K and 10-Q and, when coupled with EGC status, whether a registrant needs to obtain an attestation report from its auditors on ICFR. Once the SPAC has completed the acquisition of the operating company, the post-merger registrant will retain its filing status until its next determination date. Registrants determine filing status on the last day of each fiscal year using public float as of the last business day of the most recently completed second fiscal quarter. Changes in filing status are effective for the Form 10-K filed for that fiscal year.

In 2020, the SEC amended the definition of “accelerated filer” and “large accelerated filer.” For more information on these amendments, refer to [NDS 2020-05, “SEC amends ‘accelerated filer’ and ‘large accelerated filer’ definitions.”](#)

SRC status

Scaled disclosure alternatives are available for registrants meeting the definition of an SRC. Among other benefits, SRCs are permitted to follow the financial statement requirements in Regulation S-X, Article 8, *Smaller reporting companies*, which permits a maximum of two annual periods in filings. SRC status is determined annually based on the public float of the registrant on the last business day of its second fiscal quarter and annual revenues for the most recently completed fiscal year as of that date.

The SEC staff looks to the private operating company’s eligibility as an SRC at the time of the acquisition for purposes of the disclosures to be provided in the Super 8-K.¹⁵ However, if the SPAC is an SRC, the registrant would continue to qualify as an SRC until the next determination date, even if the Super 8-K disclosures were not scaled because the private operating company was not eligible at the time of the transaction.¹⁶ See [NDS 2020-05](#) for details on qualification thresholds and the relationship between SRCs and non-accelerated, accelerated, and large accelerated filers.

EGC status

EGCs are afforded certain reduced regulatory and disclosure alternatives and are exempt from compliance with certain requirements applicable to non-EGCs. Notable accommodations include an exemption from both the auditor attestation on ICFR and the requirement to report critical audit matters in the independent auditor’s report. EGCs are also subject to the reduced reporting requirements regarding executive compensation afforded to SRCs.

The post-merger registrant’s evaluation of EGC status may differ depending on the accounting acquirer determination. FRM Section 10120.2 includes guidance on assessing EGC eligibility subsequent to a merger transaction. Figure 2.2 presents a modified reproduction of that guidance. In Example 1, Company A (SPAC) acquires Company B (private operating company) for cash or stock in a forward acquisition on October 1, 20X1. Company A is both the legal acquirer and the accounting acquirer. In Example 2, Company C (SPAC) undertakes a reverse merger with Company D (a private operating company) on October 1, 20X1. The evaluation of Company A’s and Company C’s eligibility as an EGC post-transaction should be considered as shown in Figure 2.2.

¹⁵ See FRM Sections 5130.1 and 5230.1.

¹⁶ See FRM Section 5230, “Reverse acquisitions.”

Figure 2.2 – Evaluating eligibility as an EGC

	Example 1: forward acquisition (SPAC is the accounting acquirer)	Example 2: reverse merger (private operating company is the accounting acquirer)
\$1.07B annual revenues test	Look to Company A's revenues, which will include Company B's revenues from Oct. 1, 20X1.	Look to Company D's revenues, which will include Company C's revenues from Oct. 1, 20X1.
Five-year anniversary test	Look to Company A's date of first sale.	Look to Company C's date of first sale.
\$1B issued debt during previous three years test	Look to Company A's debt issuances, which will include Company B's debt issuances from Oct. 1, 20X1.	Look to Company D's debt issuances, which will include Company C's debt issuances from Oct. 1, 20X1.
Large accelerated filer test	At Dec. 31, 20X1, look to Company A's market value at June 30, 20X1.	At Dec. 31, 20X1, look to Company C's market value at June 30, 20X1.

The registrant would reassess its EGC status upon consummation of the merger. Once the registrant loses EGC status, that status cannot be regained.

2.3 Filings after consummation of the transaction

Following the completion of the SPAC acquisition, the combined entity must file periodic Exchange Act reports on Forms 10-Q and 10-K. The due dates of such reports will be based on the registrant's filing status. For considerations related to the accounting acquirer determination and the presentation of equity in the registrant's post-merger filings, refer to Section 3, "Accounting considerations in SPAC transactions."

Form S-3 eligibility

In its interpretive guidance,¹⁷ the SEC staff has addressed eligibility for Form S-3 following a private operating company's merger with a public shell company. In most situations, the staff will not accelerate the effectiveness of a registration statement on Form S-3 if the combined entity lacks a 12-month history of Exchange Act reporting. However, the registrant may file a registration statement on Form S-1 during this period.

¹⁷ See CorpFin's [Compliance and Disclosure Interpretations, Securities Act Forms](#), Question 115.18.

Management's report on ICFR

The SEC staff has clarified¹⁸ that its interpretive guidance regarding the potential to exclude recent acquirees from management's assessment of ICFR does not apply to a public shell company's acquisition of a private operating company that is accounted for as a reverse merger. The staff has further clarified that the surviving issuer (operating company) is not a "newly public company"¹⁹ and does not qualify for the omission of management's assessment of ICFR pursuant to S-K Item 308(a) in its first annual report filed subsequent to the consummation of the transaction.

However, the staff acknowledges that it may not always be possible to conduct an assessment of ICFR for the operating company prior to the end of the fiscal year in which the acquisition is consummated. Further, irrespective of the accounting treatment, the internal controls of the legal acquirer (public shell) may no longer exist as of the assessment date, or the assets, liabilities, and operations may be insignificant compared to those of the combined entity. In such situations, the staff may not object if the registrant excludes management's assessment of ICFR from its annual report on Form 10-K for the fiscal year in which the transaction is consummated.

If management's assessment of ICFR is omitted from Form 10-K, the registrant should disclose why such an assessment has not been included, addressing the effect of the transaction on management's ability to conduct an assessment. Notwithstanding the exclusion of management's report on ICFR, the registrant is subject to Section 404(a) of the Sarbanes-Oxley Act. Accordingly, it should include the ICFR language in the introductory portion of paragraphs 4 and 4(b) of the Section 302 certifications.

Further, the staff guidance relates only to management's assessment of ICFR and does not encompass DCP. Management must continue to include its assessment of DCP in each of the quarterly reports on Form 10-Q as well as in the annual report on Form 10-K.



Grant Thornton insights: Acquisitions consummated shortly after an operating company's year-end

Companies should note that when the acquisition occurs after the most recent fiscal year-end of the operating company but before the financial statements for that annual period are required in a Form 10 registration statement, the registrant is required to amend the Super 8-K to update for the annual financial statements of the operating company.²⁰ The SEC staff clarified²¹ that such an amendment is considered equivalent to filing the first Form 10-K subsequent to the consummation of the transaction. In such instances, Form 10-K filed for the year in which the transaction is consummated must include management's assessment of ICFR.

¹⁸ See CorpFin's [Compliance and Disclosure Interpretations, Regulation S-K](#), 215.02.

¹⁹ Management's report under Section 404(a) is required for all SEC registrants. A "newly public company" is not required to provide management's report until its second annual report. A "newly public company" is a registrant that had neither been required to file an annual report for the prior fiscal year with the Commission nor had filed an annual report with the Commission for the prior fiscal year (see the SEC Final Rule, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers and Newly Public Companies*).

²⁰ See FRM Section 12220.1c.

²¹ See CorpFin's [Compliance and Disclosure Interpretations, Regulation S-K](#), 215.02

3. Accounting considerations in SPAC transactions

ASC 805, *Business Combinations*, provides guidance on the accounting for merger transactions, including those that are determined to be business combinations, reverse mergers, or asset acquisitions. While transactions in which a SPAC acquires a private operating company are similar to mergers between entities that are not SPACs, there are some unique accounting considerations related to SPAC transactions.

The following discussion relates to the financial statements prepared under U.S. GAAP included in the combined entity's relevant SEC filings (see Section 1 and Section 2) following a SPAC transaction, as well as considerations for "cheap stock" that may apply to the operating company's historical financial statements.

3.1 Determining the accounting acquirer in ASC 805

When a reporting entity obtains control of a business, the reporting entity applies the acquisition method of accounting for the assets and liabilities of the acquired business under ASC 805. The acquisition method of accounting results in recognizing all of the acquired identifiable assets and liabilities of the business (with limited exceptions) at fair value. This method might also result in the acquirer recognizing goodwill or, in limited circumstances, a bargain purchase gain.

The acquisition method only applies, however, if the accounting acquiree meets the definition of a business in ASC 805. Therefore, the first step in analyzing an acquisition transaction is to determine whether the acquired set of assets and activities constitutes a business under ASC 805. For more on applying the definition of a business, including the single or similar asset threshold (also known as "the screen"), see [NDS 2017-01](#), "Amendments clarify the definition of a 'business': FASB issues ASU 2017-01."

An important step in every business combination is determining which one of the combining entities is the acquirer for accounting purposes. ASC 805 provides a framework for identifying the acquirer, which requires an entity to exercise judgment and might result in identifying an entity other than the legal acquirer as the acquirer for accounting purposes.



ASC 805-10-25-4

For each business combination, one of the combining entities shall be identified as the acquirer.

ASC 805-10-25-5

The guidance in the General Subsections of Subtopic 810-10 related to determining the existence of a controlling financial interest shall be used to identify the acquirer – the entity that obtains control of the acquiree. If a business combination has occurred but applying that guidance does not clearly indicate which of the combining entities is the acquirer, the factors in paragraphs 805-10-55-11 through 55-15 shall be considered in making that determination. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

The determination of which party, if any, is the primary beneficiary of a VIE shall be made in accordance with the guidance in the Variable Interest Entities Subsections of Subtopic 810-10, not by applying either the guidance in the General Subsections of that Subtopic, relating to a controlling financial interest, or in paragraphs 805-10-55-11 through 55-15.

If the business combination is between entities under common control, then the acquisition method of accounting is not applicable, and the guidance in ASC 805-50 regarding common control transactions should be applied instead.



Grant Thornton insights: Common control transactions

The FASB Accounting Standards Codification does not include a definition of “common control.” In practice, entities with a common parent entity, as determined under ASC 810, *Consolidation*, are generally considered to be under common control.

EITF Issue 02-5, “Definition of ‘Common Control’ in Relation to FASB Statement No. 141,” which was never finalized or codified, has also been applied in practice to determine when entities are under common control. EITF Issue 02-5 indicates that common control would exist in any of the following situations:

- An individual (including trusts in which the individual is the beneficial owner) or entity holds more than 50 percent of the voting ownership of each entity.
- Immediate family members hold more than 50 percent of the voting ownership interest of each entity, and there is no evidence that those family members would vote their shares in any way other than in concert. Immediate family members include a married couple and their children, but not the married couple’s grandchildren. Entities might be owned in varying combinations among living siblings and their children. Those situations would require careful consideration of the substance of the ownership and voting relationships.
- A group of shareholders holds more than 50 percent of the voting ownership of each entity, and contemporaneous written evidence of an agreement to vote a majority of the entities’ shares in concert exists.

We also believe that if a common ownership group controls multiple entities, but no single party individually controls the entities, common control would not exist unless there is contemporaneous written evidence of an agreement to vote a majority of the entities’ shares in concert. For example, if individual A owns 75 percent of Entity 1 and 25 percent of Entity 2, and individual B owns the remaining 25 percent of Entity 1 and 75 percent of Entity 2, those entities would *not* be under common control.

If a business combination is not conducted between entities under common control, then the combined entity should first consider whether any of the combining entities is a variable interest entity (VIE) and which, if any, of the other combining entities is the primary beneficiary of the VIE. The primary beneficiary of a VIE is always the accounting acquirer, according to the guidance in ASC 805-10-25-5. For more on

determining whether an entity is a VIE and on identifying the primary beneficiary of a VIE, see [NDS 2017-03](#), “Step-by-step approach to applying the VIE consolidation model: Updated for ASU 2015-02, *Amendments to the Consolidation Analysis*.”

If none of the combining entities is a VIE, then the combined entity should consider whether the voting model subsections in ASC 810 clearly indicate which of the combining entities is the accounting acquirer. However, if the acquisition is effectuated, at least in part, by the exchange of equity interests, then it might not be clear which of the combining entities is the accounting acquirer, particularly when the selling shareholders of the legal acquiree obtain a significant equity interest in the combined entity. In such circumstances, the combined entity should instead consider the guidance in ASC 805-10-55-11 through 55-13. The guidance in ASC 805-10-55-11 states that the acquirer is usually the entity that transfers the cash or other assets or incurs the liabilities.

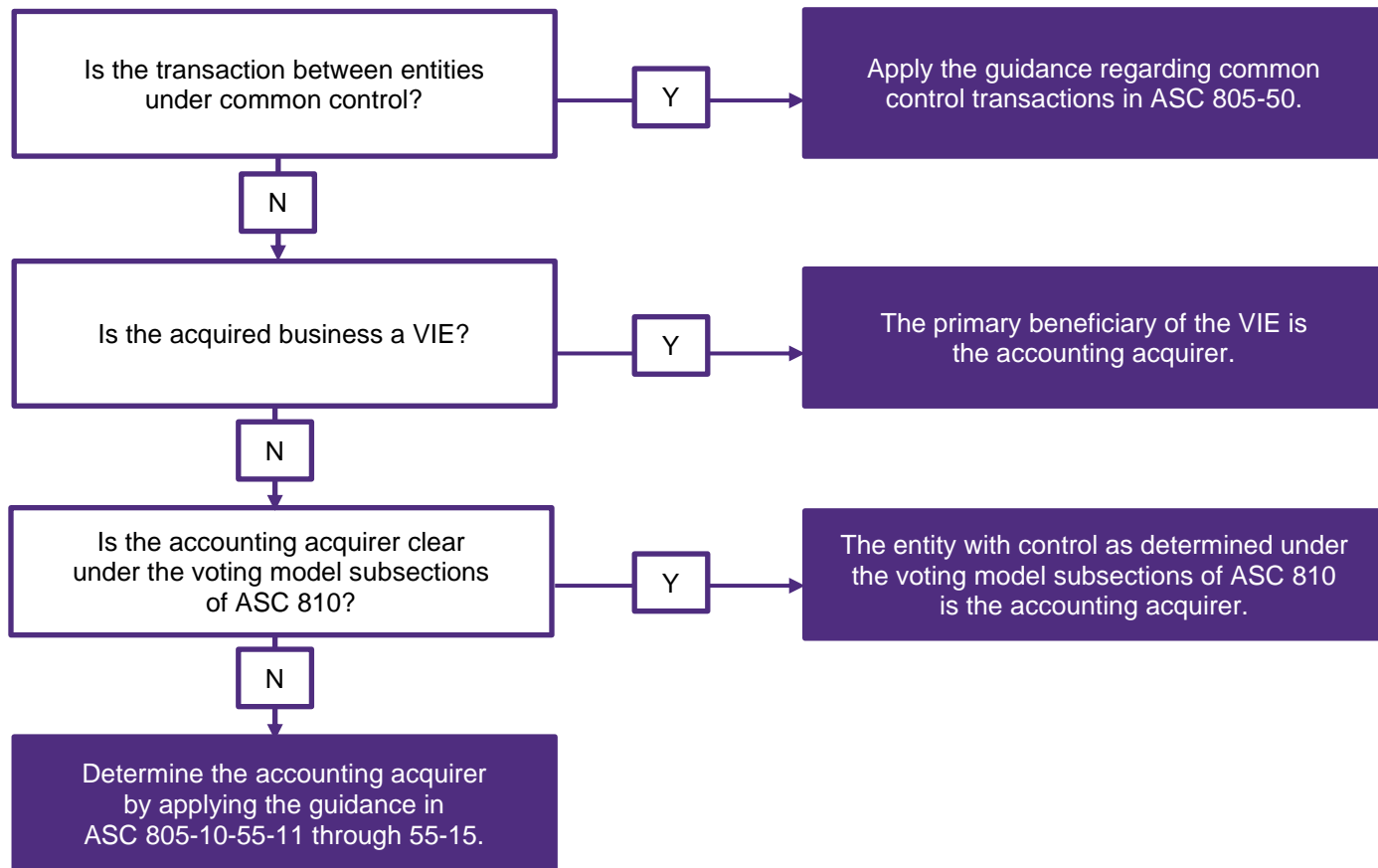
Figure 3.1 – Other factors to consider when the accounting acquirer is not clear

Indicators of accounting acquirer: ASC 805-10-55-12 through 55-13
Relative voting rights in the combined entity held by the shareholders of the precombination entities
Existence of a large minority voting interest in the combined entity
The composition of the governing body of the combined entity
The composition of senior management of the combined entity
The terms of exchange of equity interests and whether one of the combining entities paid a premium
The relative size of the combining entities

ASC 805 does not establish a hierarchy among these factors, so judgment is required in identifying the accounting acquirer in a business combination.

Additionally, business combinations involving more than two entities should be evaluated using the guidance in ASC 805-10-55-14, while business combinations involving a newly formed entity should be evaluated using the guidance in ASC 805-10-55-15. An entity formed to effect a business combination that has no substantive precombination activities and effects the combination by issuing equity interests is generally not the accounting acquirer. However, if that entity has substantive precombination activities, or if the newly formed entity effects the transaction primarily by transferring assets or incurring liabilities, the newly formed entity might be the acquirer. Determining the accounting acquirer requires the exercise of significant judgment, and all facts and circumstances should be considered.

The framework for determining the accounting acquirer for business combinations that are not between entities under common control (as described above) is illustrated in Figure 3.2.

Figure 3.2 – General framework for determining the accounting acquirer

3.1.1 Identifying the accounting acquirer in SPAC transactions

In a SPAC transaction, the SPAC typically issues a combination of cash and the SPAC's equity shares to the owners of the private operating company in exchange for ownership interests in the private operating company. If the SPAC transaction is not conducted between entities under common control and the accounting acquiree meets the definition of a business, then the SPAC transaction should be accounted for as a business combination. Because the SPAC is an entity created to effect a business combination typically by issuing a combination of cash and shares (with the number of shares often representing a significant ownership interest in the combined entity), it is not generally obvious which entity is the accounting acquirer.

Analyzing indicators to determine which entity is the accounting acquirer

While a SPAC is an entity created to effect a business combination, it typically conducts substantive precombination activities in the form of raising capital from outside investors and developing processes to identify and evaluate acquisition targets. As a result, a SPAC is typically not precluded from being considered the accounting acquirer, as contemplated under ASC 805-10-55-15. Therefore, if it is not obvious which entity is the accounting acquirer under the guidance in ASC 810, the relevant considerations enumerated in ASC 805-10-55-11 through 55-14 should be considered.

One of the indicators in ASC 805-10-55-12(a) to consider when identifying the accounting acquirer in a business combination is the relative voting rights held by the shareholders of the precombination entities in the combined entity after the transaction has been finalized. The acquirer usually is the entity whose shareholders, as a group, retain or receive the largest portion of the voting rights of the combined entity. The guidance in ASC 805 specifies that entities should consider the existence of any unusual or special voting arrangements, as well as options, warrants, or convertible securities, when considering the relative voting rights in the combined entity for purposes of determining the accounting acquirer. In a proposed SPAC merger, the combining entities need to analyze all facts and circumstances of a contemplated transaction *before* filing Form S-4 (as discussed in Section 1) to determine which pro forma information to include in Form S-4. However, assessing the relative voting rights of the combined entity before the transaction is consummated may be particularly challenging due to the redemption rights held by the SPAC's shareholders and the involvement of PIPE investors.



Grant Thornton insights: Assessing relative voting rights when determining the accounting acquirer

As discussed in Section 1.2.2, in a SPAC merger transaction, a number of existing shareholders in the SPAC may choose to redeem their ownership interest rather than continue as owners in the post-merger entity. To minimize the risk of the transaction failing due to excessive redemptions, the SPAC may obtain additional financing from its sponsor, or committed debt or equity financing, often referred to as PIPE (private investment in public equity). Generally, PIPEs are funded contemporaneously with the consummation of a qualifying business combination, with PIPE subscribers becoming Class A shareholders in the combined entity.

When considering the relative voting rights of the shareholders of the precombination entities for purposes of determining the accounting acquirer, questions may arise as to whether the voting rights of the PIPE investors should be attributed to the precombination shareholders of the SPAC or to the precombination shareholders of the operating company, or if they should be considered separately. When making this determination, entities should consider factors such as whether the PIPE subscribers are related parties to either precombination shareholder group and whether one of the

combining entities organized the PIPE. All facts and circumstances of the arrangement and relationships of the parties should be considered.

Further, because the level of redemptions by the Class A shareholders of the SPAC will not be known until the closing of the merger, it is possible that the SPAC's precombination shareholders may have a majority of the voting rights in the combined entity under a "no redemption" scenario, while the private operating company's precombination shareholders may have a majority of the voting rights in the combined entity under a "maximum redemption" scenario (meaning the maximum number of redemptions that can occur and still allow the merger transaction to close). Accordingly, when determining which of the combining entities is the accounting acquirer for purposes of including the appropriate pro forma financial information in Form S-4, an entity generally needs to consider relative voting rights under both a "no redemption" and a "maximum redemption" scenario.

As mentioned in Section 1.2.2, when a range of redemption scenarios is possible, the pro forma financial information should be prepared to reflect the appropriate accounting in each of these respective scenarios in accordance with S-X Rule 11-02(a)(10), which requires additional pro forma presentations that show a range of possible results. Since the actual redemptions are unknown when the Form S-4/merger proxy is being prepared, the pro forma financial information ordinarily reflects both a "no redemption" scenario and a "maximum redemption" scenario, as well as any contemplated additional financing.



Attribution of PIPE investors when determining the accounting acquirer

The following example illustrates whether the voting rights obtained by the PIPE subscribers in a SPAC transaction would be attributed to the precombination shareholders of the SPAC or to the precombination shareholders of the private operating company, or if they should be considered separately, for purposes of analyzing the relative voting rights indicator in ASC 805-10-55-12(a). However, determining the accounting acquirer in a SPAC transaction will generally require considering all of the indicators in ASC 805-10-55-12 and 55-13.

Example

SPAC acquires 100 percent of the shares of OpCo in exchange for Class A shares and cash in the combined entity. After redemptions occur, the precombination shareholders of OpCo own 45 percent of the Class A shares of the combined entity, the precombination shareholders of SPAC own 40 percent of the combined entity's Class A shares, and PIPE investors own 15 percent of the combined entity's Class A shares. The PIPE investors consist exclusively of precombination shareholders of OpCo.

In considering the relative voting rights in the combined entity for purposes of determining the accounting acquirer, the combined relative voting rights held by precombination shareholders of OpCo and PIPE investors total 60 percent, compared to 40 percent of SPAC's voting rights.

Another factor to consider in determining the accounting acquirer when it is not otherwise obvious is the relative size of the combining entities, which can be measured in assets, revenues, or earnings, for example, as described in ASC 805-10-55-13. This indicator may require significant judgment when one of the combining entities is a SPAC due to the unique nature of SPAC entities.



Grant Thornton insights: Considering relative size when determining the accounting acquirer

One of the indicators considered in identifying the accounting acquirer when the determination is not otherwise clear is the relative size of the combining entities. However, when the combining entities are involved in different businesses or activities, a comparison of the reported amounts of their revenues, earnings, or assets may be less meaningful. Additionally, comparing the reported amounts of total assets or net assets when one of the combining entities has significant internally developed intangible assets may also be less meaningful.

A SPAC is a shell company formed solely for the purpose of acquiring an operating company. It does not have revenue or material assets other than monetary assets and is not comparable to an operating company. Accordingly, in business combinations with a SPAC, we believe that less weight should be given to the comparison of the relative size of the combining entities when considering all of the factors in ASC 805-10-55-11 to 55-13 for the purpose of determining the accounting acquirer.

Impact of the legal structure of the combined entity on determining the accounting acquire

The legal structure of the combined entity following a SPAC transaction may also influence the determination of the accounting acquirer. For instance, SPAC transactions may take the form of an UP-C transaction. In SPAC transactions that utilize the UP-C structure, the private operating company is commonly considered a VIE and the SPAC is the primary beneficiary, in which case, the SPAC would, by definition, be the accounting acquirer (provided there is an ultimate change in control over the VIE and the transaction is not otherwise between entities under common control).



Grant Thornton insights: UP-C transactions

An UP-C structure is a transaction in which the pre-transaction owners of an entity treated as a pass-through entity for tax purposes (such as a limited partnership) retain direct ownership in the private operating limited partnership, while new public investors own an indirect interest in the limited partnership through the public SPAC.

Generally, the pre-transaction owners of the limited partnership retain a nonvoting limited partnership interest in the limited partnership, while the SPAC owns similar nonvoting limited partnership interests and becomes the limited partnership's general partner. Since the limited partnership interests are nonvoting, they typically lack kick-out rights over the SPAC as general partner. As a result, the limited partnership qualifies as a VIE under the guidance in the VIE subsections of ASC 810. Additionally, the SPAC is generally considered to be the primary beneficiary of the VIE by virtue of its status as both limited partner (providing the SPAC with a variable interest) and general partner (providing the SPAC with power).

UP-C transactions can be complex. For more on the accounting and financial reporting considerations pertinent to UP-C transactions, see our publication, "[Accounting considerations for UP-C transactions.](#)"

If the assessment of all relevant factors results in the determination that the SPAC is the accounting acquirer, then the SPAC should apply the acquisition method of accounting to the acquired private operating company's identifiable assets and liabilities. Additionally, the results of the operating company should be reflected in the financial statements of the combined entity prospectively from the acquisition date, and the combined entity should provide all of the disclosures required under ASC 805 applicable to the combination.

However, if the SPAC is not identified as the accounting acquirer, then the transaction should be accounted for in a manner that is similar to a reverse acquisition, as described below.

3.1.2 Reverse acquisitions

If the private operating company (legal acquiree) is determined to be the accounting acquirer of the SPAC, the transaction is accounted for in a manner that is similar to a reverse acquisition, which is often referred to as a reverse merger, under the guidance in ASC 805-40. Generally, a SPAC's only precombination identifiable assets are the cash received from its public investors, and although a SPAC will have substantive precombination activities, a SPAC does not usually meet the definition of a business in ASC 805. As a result, a reverse merger with a SPAC is typically accounted for as a reverse recapitalization, similar to a reverse acquisition between an operating company and a shell company, as described in FRM Topic 12, *Reverse Acquisitions and Reverse Recapitalizations*. Reverse recapitalizations are accounted for as capital transactions by the accounting acquirer and are considered to be the equivalent of the operating company issuing shares for the net monetary assets of the SPAC, followed by a recapitalization (the operating company takes on the capital structure of the SPAC). In a reverse recapitalization, goodwill is not recognized.

Because reverse recapitalizations are treated as capital transactions, the combined entity should consider the guidance in ASC 505 on equity issuance costs. Under this guidance, costs incurred by the accounting acquirer are treated as follows:

- Costs that are not direct and incremental to the issuance of equity are expensed.
- Costs that are direct and incremental to the issuance of new shares are treated as a reduction of the proceeds raised (that is, the net monetary assets of the SPAC).

As described in ASC 805-40-45-2, the financial statements of the combined entity are treated as a continuation of the private operating company's financial statements, with no adjustments made to the operating company's historical revenues, expenses, assets, or liabilities. However, while historical total equity is not adjusted, the components of historical total equity—and historical EPS information—are generally retrospectively adjusted to reflect the capital structure of the SPAC (the legal acquirer), analogizing to the reverse acquisitions guidance in ASC 805-40-45-3 through 45-5.

Operating entity is organized as a corporation

If the private operating entity is organized as a corporate entity and uses captions in its equity statement that are commonly used by corporations, such as common stock, additional paid-in capital (APIC), and retained earnings, then the historical equity of the combined entity should be presented as follows:

- *Common stock*: Both the number of shares outstanding and their par value are retrospectively adjusted for all prior periods presented to reflect the par value of the outstanding stock of the SPAC as a result of the SPAC transaction. Any resulting adjustment to the operating company's historical common stock is offset against APIC.
- *Retained earnings*: Retained earnings are not adjusted.

- *APIC*: APIC is retrospectively adjusted for all prior periods presented for any necessary modifications to common stock, but the addition of the net monetary assets of the SPAC is recognized on the date of the SPAC transaction.

To determine the historical shares outstanding in prior periods for presentations of the historical statement of changes both in shareholders' equity and in basic and diluted EPS, the same weighted-average shares outstanding are used, adjusted by the exchange ratio between the operating company and the SPAC. The following example illustrates the adjustments to the operating company's historical equity presentation.



Presentation of historical equity statements when operating entity is a corporation

SPAC and OpCo agree to consummate a merger on 12/31/X3. The balance sheets of OpCo and SPAC immediately preceding the SPAC transaction are as follows.

Carrying balances of OpCo and SPAC immediately preceding the SPAC transaction

	OpCo		SPAC	
Total Assets		\$ 50,000		\$ 50,000
Total Liabilities		(10,000)		-
Net Assets		40,000		50,000
Common Stock	100 Shares	100	500 Shares	500
APIC		31,900		49,500
Retained Earnings		8,000		-
Total Shareholders' Equity		\$ 40,000		\$ 50,000

OpCo is a private operating company that is organized as a corporation with an acquisition date fair value of \$80/share (total value of \$80,000). SPAC acquires all of the outstanding shares of OpCo from the shareholders of OpCo in exchange for a combination of 375 newly issued SPAC shares and the net monetary assets of the SPAC.

While the SPAC is the legal acquirer of OpCo, the sellers of OpCo receive a significant percentage of the combined entity's outstanding equity, so that it is unclear who is the accounting acquirer under the guidance in ASC 810. As a result, OpCo considers all of the factors in ASC 805-10-55-11 through 55-15 and concludes that OpCo is the acquirer for accounting purposes. Accordingly, the SPAC transaction is accounted for as a reverse recapitalization of OpCo.

After the reverse recapitalization, there are 875 total shares of the combined entity outstanding (SPAC's initial 500 shares, plus 375 additional shares issued to the former shareholders of OpCo as a result of the SPAC transaction), resulting in the following adjustments to OpCo's balance sheet.

Combination of OpCo and SPAC upon SPAC transaction

	OpCo	Adjustments	Combined
Total Assets	\$ 50,000	\$ 50,000	\$ 100,000
Total Liabilities	(10,000)	-	(10,000)
Net Assets	40,000	50,000	90,000

Common Stock	100	775	875
APIC	31,900	49,225	81,125
Retained Earnings	8,000	-	8,000
Total Shareholders' Equity	\$ 40,000	\$ 50,000	\$ 90,000

Concurrent with the SPAC transaction, the historical equity accounts of OpCo are retrospectively adjusted to reflect the capital structure of the SPAC by analogizing to the reverse acquisition guidance in ASC 805-40-45-3 through 45-5. Based on this analysis, OpCo presents these adjusted amounts in the accounting acquirer's "recast" statements of changes in shareholders' equity as follows.

Historical OpCo Statements of Changes in Shareholders' Equity

	Common stock		Retained earnings	APIC	Total
	Shares	Amount			
1/1/X1	\$ 100	\$ 100	\$ 5,000	\$ 31,900	\$ 37,000
Net Income			1,500		1,500
12/31/X1	100	100	6,500	31,900	38,500
Net Income			1,000		1,000
12/31/X2	100	100	7,500	31,900	39,500
Net Income			500		500
12/31/X3	100	100	8,000	31,900	40,000

Recast OpCo Statements of Changes in Shareholders' Equity

	Common Stock		Retained earnings	APIC	Total
	Shares	Amount			
1/1/X1	\$ 375	\$ 375	\$ 5,000	\$ 31,625	\$ 37,000
Net Income			1,500		1,500
12/31/X1	375	375	6,500	31,625	38,500
Net Income			1,000		1,000
12/31/X2	375	375	7,500	31,625	39,500
Net Income			500		500
SPAC Transaction		500		49,500	50,000
12/31/X3	875	875	8,000	81,125	90,000

The retrospective adjustments to historical shares outstanding are based on the exchange ratio established in the SPAC transaction (375 SPAC shares for all 100 shares of OpCo, or an exchange ratio of 3.75 to 1.0). Had the number of shares in OpCo's historical periods varied (due to share issuances, treasury stock transactions, or stock dividends, for example), the same exchange ratio of 3.75 would have been applied to determine the weighted-average shares outstanding for purposes of calculating EPS in historical periods.

Operating entity is organized as a partnership

If the private operating entity is organized as a partnership or a similar entity and does not distinguish between retained earnings and partners' contributed capital, it might be impractical to retrospectively adjust the historical equity accounts of the operating entity to reflect the capital structure of the SPAC. In these instances, the combined entity should present the SPAC's capital structure from the transaction

date going forward, and OpCo's historical equity presentation prior to the SPAC transaction is not impacted. In such circumstances, the OpCo historical financial statements generally do not present EPS.



Presentation of historical equity statements when operating entity is a partnership

SPAC and OpCo agree to consummate a merger on 12/31/X3. The balance sheets of OpCo and SPAC immediately prior to the SPAC transaction are as follows.

Carrying balances of OpCo and SPAC immediately preceding the SPAC transaction

	<u>OpCo</u>		<u>SPAC</u>
Total Assets	\$ 50,000		\$ 50,000
Total Liabilities	(10,000)		-
Net Assets	40,000		50,000
Common Stock	-	500 Shares	500
APIC	-		49,500
Retained Earnings	-		-
Partners' Capital	40,000		-
Total Equity	\$ 40,000		\$ 50,000

OpCo is a private operating entity organized as a partnership that does not distinguish between retained earnings and partners' contributed capital. On the date of the SPAC transaction, the fair value of OpCo is \$80,000. SPAC acquires all of the outstanding partnership interests of OpCo from the partners of OpCo in exchange for a combination of 375 newly issued SPAC shares and the net monetary assets of the SPAC.

While SPAC is the legal acquirer of OpCo, consideration of all factors in ASC 805-10-55-11 through 55-15 result in the conclusion that OpCo is the acquirer for accounting purposes. Accordingly, the SPAC transaction is accounted for as a reverse recapitalization of OpCo.

After the reverse recapitalization, there are 875 total shares of the combined entity outstanding (SPAC's initial 500 shares plus 375 additional shares issued to the former partners of OpCo as a result of the SPAC transaction), resulting in the following adjustments to OpCo's balance sheet.

Combination of OpCo and SPAC upon SPAC transaction

	<u>OpCo</u>	<u>Adjustments</u>	<u>Combined</u>
Total Assets	\$ 50,000	\$ 50,000	\$ 100,000
Total Liabilities	(10,000)	-	(10,000)
Net Assets	40,000	50,000	90,000
Common Stock		875	875
APIC		89,125	89,125
Retained Earnings			
Partners' Capital	40,000	(40,000)	
Total Equity	\$ 40,000	\$ 50,000	\$ 90,000

Concurrent with the SPAC transaction, the historical equity accounts of OpCo are adjusted to reflect the capital structure of the SPAC by analogizing to the reverse acquisition guidance in ASC 805-40-45-3 through

45-5. As a result, OpCo determines that it is impractical to recast prior-period equity to reflect the capital structure of the SPAC. Rather, the combined entity reflects the SPAC's capital structure from the transaction date going forward.

Historical Statements of Changes in Partners' Capital

	<u>Partners' Capital</u>	<u>Total Equity</u>
1/1/X1	\$ 37,000	\$ 37,000
Net Income	1,500	1,500
12/31/X1	38,500	38,500
Net Income	1,000	1,000
12/31/X2	39,500	39,500
Net Income	500	500
12/31/X3	40,000	40,000

Recast Statements of Changes in Partners'/Shareholders' Equity

	<u>Partners' Capital</u>	<u>Common Stock</u>			<u>APIC</u>	<u>Total Equity</u>
		<u>Shares</u>	<u>\$</u>			
1/1/X1	\$ 37,000			-	\$ 37,000	
Net Income	1,500				1,500	
12/31/X1	38,500			-	38,500	
Net Income	1,000				1,000	
12/31/X2	39,500			-	39,500	
Net Income	500				500	
SPAC Transaction	(40,000)	875	875	89,125	50,000	
12/31/X3			875	89,125	90,000	

3.2 Contingent payments in SPAC transactions

Some SPAC transactions are structured with contingent payments, typically in the form of additional shares that are issued by the SPAC to the selling owners of the private operating company, its employees, or certain service providers if certain conditions are met. For example, the selling equity holders of the private operating company might receive additional shares in the combined entity if the combined entity meets certain earnings targets.

These contingent payment arrangements may also be structured so that the SPAC transfers its shares to an escrow account prior to the transaction, and the shares are contingently released to the beneficiaries when, or if, the contingencies are met. These contingent payment arrangements are frequently referred to as "earnout provisions," and their accounting can be complex, often depending in large part on whether the SPAC or the operating company is identified as the accounting acquirer and whether the recipients of any contingent payments are continuing employees of the combined entity. See Section 4.2 on share-settled earnout arrangements.

Contingent payment arrangements are either contingent compensation arrangements that must be evaluated in accordance with ASC 805 or compensation arrangements that must be accounted for in accordance with ASC 718, *Compensation – Stock Compensation*.

3.2.1 Contingent consideration arrangements

If the SPAC is identified as the accounting acquirer and the operating company meets the definition of a business, then the SPAC would evaluate the terms of the contingent payment arrangement to determine whether the arrangement should be accounted for as contingent consideration under ASC 805. However, if the sellers of the operating company are also employees of the combined entity, the contingent payment instead might be accounted for as compensation for post-combination services rendered under the guidance in ASC 805-10-55-25. Generally, if the payment under the contingent arrangement is forfeited by the employee when employment is terminated, then the contingent payment is considered to be employee compensation. If the payment is not contingent upon continuing employment, then the remaining seven factors in ASC 805-10-55-25, described in Figure 3.3, should also be considered to differentiate contingent consideration from employee compensation.

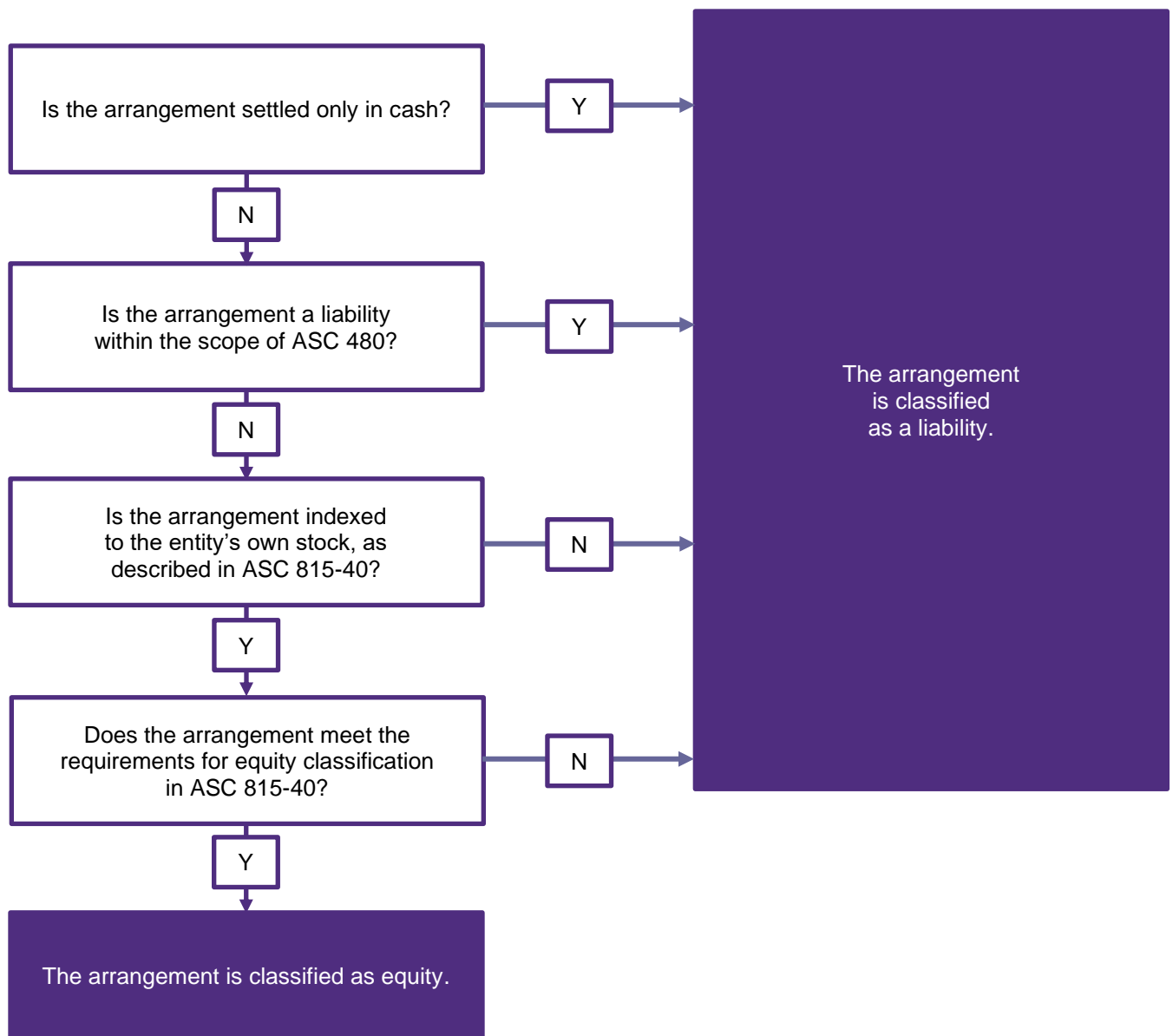
Figure 3.3 – Distinguishing contingent consideration from compensation

Factors in ASC 805-10-55-25
Payment contingent upon continuing employment
Duration of continuing employment
Level of compensation compared to that of other key employees
Similarity to any other incremental payments to employees
Level of ownership of precombination accounting acquiree
Linkage of payments to valuation of the accounting acquiree
Whether any formula for determining consideration is based on an amount meant to establish or verify the value of the accounting acquiree
Consideration of any other arrangements with the recipients of the contingent payments

If the combined entity evaluates the contingent payment and concludes that the arrangement should be accounted for as contingent consideration to the sellers of the operating company, the fair value of the contingent consideration arrangement at the transaction date is included in the value of consideration transferred in the business combination. The contingent consideration arrangement is then classified as either a liability or equity under the guidance in ASC 480-10, *Distinguishing Liabilities and Equity*, and ASC 815-40, *Derivatives and Hedging – Contracts in an Entity's Own Equity* (sometimes referred to

together as the “financial instrument roadmap”), as illustrated in Figure 3.4. Liability-classified contingent consideration arrangements are subsequently measured at fair value through the final settlement date, with changes in fair value recognized in earnings, while equity-classified contingent consideration arrangements are generally not remeasured subsequent to initial recognition.

Figure 3.4 – Financial instrument roadmap for classifying contingent consideration



3.2.2 Compensation arrangements

Contingent payment arrangements settled by issuing the shares of a SPAC to employees (sometimes including employees who are also selling equity holders of the operating company, as described in the preceding section) or to service providers of the combined entity are generally accounted for as stock compensation arrangements under ASC 718. For more information on accounting for share-based payment awards, see our guide to [Share-Based Payments – Navigating the Guidance in ASC 718](#).

Employee awards when the SPAC is the accounting acquirer

As discussed in the preceding section, when the SPAC is the accounting acquirer, contingent share issuances to selling equity holders of the operating company who are also employees of the combined entity might be considered compensation for services rendered as an employee, rather than consideration for the purchase of the employee's ownership interest, and should be accounted for under ASC 718.

Additionally, employees of the operating company (the accounting acquiree) who are not selling equity holders of the operating company may also enter into new arrangements for the contingent receipt of shares of the combined entity. Such arrangements are accounted for as the issuance of new share-based payment awards under ASC 718.

Employees of the operating company may exchange existing share-based payment awards for awards that are settled in the shares of the combined entity. The accounting for exchanges of awards as either consideration in the acquisition or as compensation cost depends upon whether the acquirer is obligated to replace the acquiree awards and whether the awards would have expired or been terminated on the acquisition date under the original award terms.

Determining whether the accounting acquirer is obligated to replace existing awards requires entities to exercise significant judgment. Replacement may be required by any one of the following factors:

- The terms of the acquisition agreement
- The terms of the accounting acquiree's awards
- Applicable laws and regulations

If the acquirer is obligated to replace the award, the portion of the fair value of the replacement award that is included in the consideration transferred in exchange for the acquiree equals the portion of the acquiree award that is attributable to precombination vesting.

As stated in ASC 805-30-30-10, if the SPAC is not required to replace the existing awards of the operating company, and if the awards would have expired or been terminated on the acquisition date under the original award terms, any replacement awards are accounted for as new awards, with compensation cost recognized in the post-combination financial statements of the combined entity.

Employee awards in a reverse recapitalization

If an employee of the historical operating company (the accounting acquirer) in a reverse recapitalization receives an earnout as a new award that is tied to future employment with the combined entity, the award is generally accounted for as the issuance of a new share-based payment award under ASC 718.

Employees of the accounting acquirer may also have existing share-based payment awards that were exchanged for awards that could be settled in shares of the combined entity. Such exchanges are accounted for under the award modification guidance in ASC 718.

3.3 Cheap stock

The SEC often scrutinizes the historical accounting for share-based payment awards of private operating companies that have issued new awards in the periods leading up to the entity's potential SPAC transaction. In particular, the SEC staff might raise questions about whether the private operating company has issued "cheap stock" awards. In simple terms, "cheap stock" awards are share-based payment awards granted during the periods leading up to a SPAC transaction at values significantly below the exit event valuation. In such circumstances, the SEC might question whether the fair values used in the private operating company's historical accounting appropriately capture the increase in fair value of the company's equity instruments that typically occurs as the SPAC transaction draws near. Considering "cheap stock" is especially important for companies that issue share-based awards in the year or so preceding the SPAC transaction.



Determining the fair value of share-based payment awards leading up to a SPAC transaction

A private operating company issued equity-classified share-based payment awards in May 2020 when it was not yet contemplating a SPAC transaction or exit strategy. The private operating company determined that its equity awards' fair value was \$3 per share. In September 2020, the company signed a letter of intent with a SPAC, with a target closing date of April 2021. In December 2020, the private operating company issued additional equity awards to senior management at \$3.25 per share.

In reviewing the filing, the SEC staff questions how the company determined that \$3.25 was the appropriate amount and asks the company to reconcile the difference between the fair value of awards and the fair value implied by the current merger transaction.

3.3.1 Accounting and valuation considerations

A private operating company anticipating a SPAC transaction should broadly consider the implications of issuing "cheap stock." ASC 718, which contains guidance on accounting for share-based payment awards, requires an entity to measure share-based payment awards initially at the grant-date fair value of the award. For share-based payment awards classified in equity under the guidance in ASC 718, the grant-date fair value of the award is not subsequently remeasured and is recognized as compensation expense in accordance with the subsequent measurement guidance in ASC 718. In contrast, liability-classified awards are revalued at each reporting period under ASC 718. For more information on accounting for share-based payment awards, see our publication, [Share-based payments – Navigating the guidance in ASC 718](#).

Determining the appropriate grant-date fair value of an award is key to avoiding having to recognize additional compensation expense for issuing "cheap stock" at the time of the SPAC transaction. For many private operating companies, this evaluation requires the assistance of independent valuation professionals. In 2013, the AICPA issued a Practice Aid, "Valuation of Privately-Held Company Equity Securities Issued as Compensation," which includes a discussion about valuation within the context of an anticipated IPO. This guidance is useful and relevant for entities anticipating a SPAC transaction to consider as they account for stock compensation.



Grant Thornton insights: Cheap stock valuation considerations

It is important to keep in mind that ASC 718 requires entities to measure share-based payment awards on the grant date. The value of an entity's equity interests could change rapidly during the period leading up to a SPAC transaction, forcing the entity to perform valuations more frequently during that period to capture changes in the value of its equity interests if it continues to make additional grants leading up to the SPAC transaction.

The AICPA's Practice Aid provides guidance on valuing privately held equity securities, beginning with the valuation of the company's equity, then allocating that enterprise value to the classes comprising the company's capital structure. According to Paragraph 49, Chapter 6, of the Practice Aid, when an entity has transparency into a near-term exit event, the allocation of the estimated enterprise value to the various equity classes of the company using a hybrid of the probability-weighted expected return method and the option pricing method might be appropriate, as these methods incorporate the expected pricing and timing of the anticipated exit event as well as the fully diluted allocation expected in an IPO exit scenario.

3.3.2 SEC guidance

In FRM Sections 7520.1 and 9520.1, the SEC staff states that entities should be able to reconcile the difference between the fair value of awards and their IPO price. Further, the staff requires entities to disclose the methods and material assumptions used in determining the fair value of the awards. If the staff ultimately concludes that the entity issued cheap stock, it will require the entity to recognize additional compensation expense, which will immediately impact earnings.

As discussed in Section 1, the SEC requires SPACs to file certain forms and financial statements when it acquires a private operating company. In its reviews of related filings, the SEC staff frequently comments on stock compensation arrangements. Entities must ensure that they are providing all information outlined in the FRM for any periods included within the filing in conjunction with a SPAC transaction.

Example SEC comment #1

Please provide us with a breakdown of all stock options and restricted stock awards granted during fiscal [year] or after and include the fair value of the underlying common stock at the date of such grants. To the extent there were any significant fluctuations in the fair values from period to period, describe for us the factors that contributed to these fluctuations, including any intervening events within the company or change in your valuation assumptions or methodology, underlying common stock used to value such awards as determined by your board of directors.

Example SEC comment #2

We note that you used third-party valuation studies to estimate the value of your common stock, Series X preferred stock, and Series X preferred warrants. Please revise your disclosures under critical accounting policies to address any material differences between the valuations used to determine those fair values relative to the fair value implied by the current merger transaction.



Grant Thornton insights: Cheap stock documentation

It is important for private operating companies to prepare robust documentation of the particular facts and circumstances surrounding each issuance of share-based payment awards leading up to a SPAC transaction. This documentation should include significant assumptions and estimates utilized for each valuation in preparation for third-party reviews (for example, auditors).

Further, the private operating company's financial statements included within the SEC filing should clearly identify all share-based payment awards granted throughout the periods presented and the grant-date fair values of each award, and should reconcile any material differences between the valuation used to determine the fair value of the awards issued leading up to the SPAC transaction.

4. Classification of SPAC shares and equity-linked contracts

A SPAC typically issues ownership interests at three different points during its lifecycle: First, to the SPAC sponsor in exchange for seed capital; second, at its IPO; and third, in the transaction to acquire the private operating entity.

The following discussion focuses on the accounting for common transactions currently observed in practice in which a SPAC issues ownership interests. However, entities should carefully consider the specific facts and circumstances of their transactions, as this is a complex area of accounting that requires judgment. Consultation with accounting advisers is encouraged.

4.1 Shares and warrants issued by a SPAC prior to an initial business combination

Upon its IPO, a SPAC commonly issues “Class A units” to third parties via a public offering. The units are typically issued for \$10 per unit and consist of both

- One Class A share
- A Class A warrant (or fraction of a warrant) with an exercise price of \$11.50 to purchase one Class A share

In addition to the Class A units, the SPAC often issues Class B shares to the SPAC sponsor at the SPAC’s formation. The SPAC sponsor also commonly purchases Class A warrants for \$1.50 per warrant.

The SPAC may also enter into other types of arrangements that may result in the contingent issuance of SPAC equity (see Section 3.2 for further discussion of contingent payments in SPAC transactions).

Generally, the Class B shares are obtained by the SPAC’s sponsor and its affiliates and give the Class B shareholders control over the SPAC. Class B shares can generally be converted into Class A shares if the SPAC consummates a qualifying business combination.

Class A shares generally have limited rights regarding the operations of the SPAC until the consummation of a qualifying business combination. However, as discussed further in Section 4.1.2, the Class A shares are generally redeemable by the holders when the SPAC announces a qualifying business combination.

4.1.1 Freestanding financial instrument analysis

The Class A units issued by a SPAC at its IPO are compound instruments consisting of both a Class A share and a Class A warrant. Accordingly, the first step in analyzing how to account for the Class A unit is to determine whether the Class A share and Class A warrant are “freestanding financial instruments,” as defined in the Codification’s Master Glossary.

Freestanding Financial Instrument

A financial instrument that meets either of the following conditions:

- a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions
- b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable

As noted above, the Class A shares and Class A warrants are issued as part of a single compound instrument, so the SPAC must assess whether the share and the warrant are both (1) legally detachable and (2) separately exercisable. Typically, the Class A shares and Class A warrants are legally detachable, as evidenced by the fact that they can be publicly traded separately following the IPO. Additionally, exercising the Class A warrants does not impact the terms and conditions of the Class A shares. Accordingly, the shares and warrants are freestanding financial instruments and should be analyzed separately.

Allocation of proceeds and costs

While the Class A shares and Class A warrants are typically separate freestanding financial instruments, they are issued as part of a single "basket" transaction. U.S. GAAP requires that the proceeds received from such a transaction be allocated to the separate freestanding financial instruments that comprise the basket. When allocating the proceeds, entities should consider the guidance in ASC 470 and ASC 815 in addition to the SEC staff's views expressed in a [2014 speech](#).²² According to this guidance, the proceeds received, and direct and incremental costs incurred, by the SPAC for issuing the Class A units must be allocated between the share and the warrant.

In practice, proceeds received from issuing Class A units are generally allocated using either the "relative fair value method" or the "residual method." The objective of both methods is to initially measure at fair value any instrument that is subsequently measured at fair value, with residual proceeds allocated to instruments that are not subsequently measured at fair value.



Grant Thornton insights: Methods for allocating proceeds from Class A units

Because Class A shares of a SPAC are typically equity-classified shares, the appropriate method for allocating the proceeds from issuing the Class A unit will generally depend upon the classification of the Class A warrant.

If the warrant is also equity-classified, then it would not be subsequently measured at fair value, similar to the Class A share. However, if the warrant is liability-classified, then it would be subsequently measured at fair value.

²² Remarks before the 2014 AICPA National Conference on Current SEC and PCAOB Developments by Hillary H. Salo, Professional Accounting Fellow, Office of the Chief Accountant.

The following table summarizes when the relative fair value method or residual method would be appropriate in allocating proceeds from Class A units.

Classification of shares and warrants	Allocation methodology
Class A shares – equity Class A warrants – equity	Relative fair value of both instruments
Class A shares – equity Class A warrants – liability	Residual method – warrants measured at fair value, with residual allocated to shares

When the relative fair value method is appropriate, entities should determine the fair value of the freestanding financial instruments independently, in accordance with ASC 820, *Fair Value Measurement*. That is, an entity should not determine the fair value of one of the freestanding financial instruments and then assume that the remaining proceeds from issuing the compound financial instrument represents the fair value of the other freestanding financial instrument. Under this method, the SPAC should make separate estimates of the fair value of the Class A shares and Class A warrants.

When only one of the instruments is subsequently measured at fair value, the residual method is generally appropriate. Under this approach, the SPAC should not recognize a “Day 1” gain on the liability-classified Class A warrants. When applying the residual approach, entities should determine the fair value of the freestanding instrument measured subsequently at fair value (the Class A warrants) in accordance with ASC 820, and then allocate the remaining proceeds to the freestanding financial instrument not measured subsequently at fair value (the Class A shares).

4.1.2 Determining the classification of Class A and Class B shares

Class A and Class B shares issued by a SPAC are a legal form of equity and therefore are primarily subject to the classification guidance in ASC 480, *Distinguishing Liabilities from Equity*. Specifically, legal form equity shares may be classified as liabilities under ASC 480 if the shares are either

- Mandatorily redeemable, or
- Represent an unconditional obligation to transfer a variable number of equity shares when that obligation is based on any of the following:
 - A fixed monetary amount known at inception
 - Variations in something other than the fair value of the issuer’s equity shares
 - Variations inversely related to changes in the fair value of the issuer’s equity shares

Additionally, since a SPAC is an SEC registrant, it must consider the guidance in ASC 480-10-S99-3A on redeemable equity securities when classifying Class A and Class B shares.

Classification of Class A shares

Class A shares typically have the following redemption rights:

- If the SPAC does not consummate a qualifying acquisition prior to a specified date (typically, two years from the IPO date), the SPAC will be liquidated and will redeem the Class A shares for approximately \$10 per share.
- If the SPAC announces an acquisition, the Class A shares can then be redeemed at the holder's option for approximately \$10 per share until the consummation of the announced acquisition.

Equity or liability classification

These redemption rights do not make the Class A shares mandatorily redeemable, because redemption is not certain to occur. Additionally, the Class A shares do not typically contain provisions that would unconditionally obligate the SPAC to deliver a variable number of shares. Accordingly, Class A shares are typically not classified as liabilities under ASC 480.

Temporary or permanent equity

While the Class A shares are not redeemable upon issuance, the combination of redemption features means that it is certain that they will become redeemable. Accordingly, the shares should be classified in temporary equity under the guidance in ASC 480-10-S99-3A.

Since the Class A shares are probable of being redeemable in the future, the SPAC must make an election to subsequently measure the Class A shares under one of two methods specified in ASC 480-10-S99-3A—the *accretion method* or the *current redemption value method*, as follows:

- *Accretion method* – Under this method, the carrying value of Class A shares are accreted to the redemption value over the period from the IPO to the redemption date, which is the earlier of either the anticipated date of the business combination or liquidation of the SPAC. To apply the accretion method, the SPAC may not assume the automatic redemption of shares at the SPAC's specified liquidation date, but must instead estimate the date when the SPAC expects to complete a business combination.
- *Current redemption value method* – Under this method, the carrying value of the Class A shares are accreted to the redemption value as of the end of the first reporting period after the IPO date. In other words, Class A shares would be remeasured to \$10 per share as of the end of the first reporting period following the IPO.



Grant Thornton insights: Subsequent measurement of SPAC Class A shares

A SPAC's Class A shares can generally be redeemed by the shareholders upon the announcement of a qualifying business combination up until the business combination is consummated. During the redemption period, redemption requests are accumulated, and all redemptions occur simultaneously immediately before the redemption period expires. However, the SPAC's organizing documents may contain a provision stipulating that if redemptions cause the SPAC's tangible net assets to fall below \$5 million, the proposed business combination transaction would be terminated, and no redemption requests would be fulfilled in connection with that proposed transaction.

We believe that under the guidance in ASC 480-10-S99-3A, all Class A shares must be presented in temporary equity, and that a provision limiting redemptions in connection with a proposed business

combination transaction, like the one described above, should not impact the presentation of a SPAC's Class A shares in temporary equity.

Finally, after a SPAC successfully completes a qualifying business combination, the redemption features of the Class A shares generally terminate. As a result, the Class A shares are typically reclassified into permanent equity following the business combination.

Classification of Class B shares

Class B shares are generally not redeemable in any circumstances, nor do they typically contain provisions that would unconditionally obligate a SPAC to deliver a variable number of shares. While Class B shares are generally converted into Class A shares upon the successful completion of a qualifying business combination, the Class A share redemption rights are generally terminated at the time of conversion. Accordingly, Class B shares are typically not classified as liabilities under ASC 480 and are not subject to the guidance in ASC 480-10-S99-3A.

SPACs should, however, consider whether Class B shares are subject to the guidance on share-based compensation in ASC 718, based on the specific facts and circumstances of their issuance. If Class B shares are subject to the guidance in ASC 718, the classification of those shares in equity or as a liability should be determined under that guidance.

EPS considerations for Class A and Class B shares

Following their IPO, SPACs generally have two classes of outstanding common equity shares—Class A and Class B. SPACs must also follow the guidance in ASC 480-10-S99-3A on reporting the impact of using the two-class method to remeasure redeemable shares on earnings per share.

4.1.3 Determining the classification of Class A warrants

Class A warrants can generally be exercised for \$11.50 for one Class A share and generally include certain contractual provisions that require careful evaluation to determine whether the SPAC may classify the warrant in equity under ASC 480 and ASC 815-40. For instance, the SPAC will generally hold certain call features over the Class A warrants that generally allow the SPAC to settle the warrants either for cash or via net share settlement.

Contracts on an entity's own shares are subject to the "financial instrument roadmap" illustrated in Figure 3.4.

Evaluating the Class A warrants under ASC 480

Similar to legal form equity shares, contracts on an entity's own equity (including warrants) must first be evaluated under ASC 480 to determine whether the contract must be classified as a liability.

Typically, the Class A warrants are not mandatorily redeemable and do not represent an obligation to transfer a variable number of equity shares. However, the Class A warrants may represent an obligation to transfer cash to repurchase the SPAC's Class A shares, as contemplated in ASC 480-10-25-8.



ASC 480-10-25-8

An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:

- a. It embodies an obligation to repurchase the issuer's equity shares or is indexed to such an obligation.
- b. It requires or may require the issuer to settle the obligation by transferring assets.

Determining if Class A warrants represent an obligation to repurchase the SPAC's own equity shares generally depends on when the warrants may be exercised and particularly on whether the warrants may be exercised before a qualifying business combination is consummated. Figure 4.1 illustrates the impact that the timing of when a warrant may be exercised by the warrant holder has on the determination of whether the warrant is classified in equity or as a liability.

Figure 4.1: Classification of Class A warrants

When Class A warrants can be exercised	Classification under ASC 480-10-25-8
Class A warrants are exercisable prior to consummation of a qualifying business combination.	Class A warrants are liabilities under ASC 480-10-25-8 because the Class A shares into which the warrants are exercisable may be redeemed at the holder's option in connection with a qualifying business combination (or mandatorily upon liquidation of the SPAC).
Class A warrants are exercisable following the consummation of a qualifying business combination.	Class A warrants are not liabilities under ASC 480-10-25-8 because the redemption rights of the Class A shares into which the warrants are exercisable have terminated by the time the warrants become exercisable.

Evaluating the Class A warrants under ASC 815-40

If the Class A warrants are not required to be classified as liabilities under ASC 480, then they must be further evaluated under the guidance in ASC 815-40 to determine whether they should be classified in equity or as a liability. The guidance in ASC 815-40 specifies that contracts in an entity's own equity must meet two conditions to be classified in equity:

- The contract must be indexed to the entity's own stock (known as the "indexation guidance").
- The contract must meet certain defined criteria for equity classification (the "equity classification guidance"). The purpose of this guidance is to determine whether the issuer controls the ability to share-settle the contract in every circumstance.

A SPAC generally has two types of Class A warrants outstanding:

- *Sponsor warrants*, which are typically issued in a private placement to the SPAC's sponsor and its related parties
- *Public warrants*, which are issued in the SPAC's IPO to its public shareholders

Typically, sponsor warrants differ from public warrants because they are not subject to certain provisions that govern public warrants, such as certain early redemption features, and they may also have different settlement terms. However, if the sponsor warrants are transferred to a warrant holder other than the sponsor or certain other "permitted transferees" (as defined in the warrant agreement), the sponsor warrants then become identical to public warrants. The provisions of public warrants, on the other hand, typically do not change depending upon who holds the warrants.

Applying the indexation guidance to Class A warrants

The indexation guidance in ASC 815-40-15 is two-step model designed to determine whether the value received by the holder of a contract involving an entity's own shares is indexed to changes in the value of the underlying shares.

The first step, described in ASC 815-40-15-7A, addresses the impact of contingent exercise provisions in the contract (if any).



ASC 815-40-15-7A

An exercise contingency shall not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:

- An observable market, other than the market for the issuer's stock (if applicable)
- An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer; earnings before interest, taxes, depreciation and amortization of the issuer; net income of the issuer; or total equity of the issuer).

Class A warrants often have exercise contingencies, including the following:

- The warrants may be exercised only if the SPAC completes a qualifying business combination; and
- The SPAC may force certain warrants to be exercised early through certain redemption features, which are typically based on the per share fair value of the shares underlying the warrants.

These contingencies are not based on either of the conditions in ASC 815-40-15-7A, so they do not prevent the Class A warrants from being indexed to the SPAC's Class A shares. Provided there are no other exercise contingencies that are based on the conditions in ASC 815-40-15-7A, the warrants should next be analyzed under the second step in the indexation guidance.

The second step of the indexation guidance addresses the impact of the Class A warrant's settlement provisions on the monetary value received by the holder, as outlined in ASC 815-40-15-7C.



ASC 815-40-15-7C

Unless paragraph 815-40-15-7A precludes it, an instrument (or embedded feature) shall be considered indexed to an entity's own stock if its settlement amount will equal the difference between the following:

- a. The fair value of a fixed number of the entity's equity shares
- b. A fixed monetary amount or a fixed amount of a debt instrument issued by the entity

For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity shall be considered indexed to the entity's own stock.

A contract on the issuer's equity is considered indexed to the entity's own shares when the settlement amount is based on the difference between (a) the fair value of a fixed number of shares, and (b) a fixed monetary amount (for example, a fixed strike price on a warrant). This criterion is often referred to as the "fixed-for-fixed" criterion. While this criterion might appear restrictive and rigid, there are two exceptions. Adjustments to the settlement provisions of a contract on an issuer's shares would not cause the contract to fail the fixed-for-fixed criterion if the adjustments either (a) constitute a "down round" provision, or (b) are based only on inputs to the pricing of a fixed-for-fixed forward or option pricing model.

Down Round Feature

A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.

A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

The guidance in ASC 815-40-15-7D through 15-7I describes settlement provisions that may alter the number of shares issued under the contract or the exercise price of the contract, and discusses whether those adjustments would result in a contract not being indexed to the issuer's stock. A common type of adjustment contemplated by this guidance is a standard antidilution adjustment, which protects the holder of the equity contract from dilution if the issuer of the contract issues shares below market value. While standard antidilution provisions may impact the exercise price of an equity-linked contract or the number of shares issued, they are designed not to alter the monetary value received by the holder of the contract and therefore do not violate the fixed-for-fixed criterion.

In addition to standard antidilution adjustments, other adjustments to the settlement amount do not preclude a warrant from being indexed to the entity's shares, provided that any variables used to adjust the settlement amount are also used as inputs in pricing a fixed-for-fixed forward or option pricing model (such as the Black-Scholes model). The guidance in ASC 815-40-15-7E includes a list of such inputs.

Evaluating the impact of settlement provisions is a complex area of accounting and requires judgment; consultation with accounting advisers is encouraged.

Figure 4.2: Inputs to fixed-for-fixed option pricing model

Illustrative inputs to fixed-for-fixed option pricing model in ASC 815-40-15-7E
Strike price of the instrument
Term of the instrument
Expected dividends or other dilutive activities
Stock borrow costs
Interest rates
Stock price volatility
The entity's credit spread
The ability to maintain a standard hedge position in the underlying shares



Grant Thornton insights: Settlement amount varies based on the warrant holder

On April 12, 2021, the SEC issued a [staff statement on accounting and reporting considerations for warrants issued by SPACs](#).

In the statement, the SEC staff evaluated a fact pattern where warrants issued by a SPAC included terms that provided for potential changes to the warrant's settlement amount depending upon the characteristics of the holder of the warrant. For example, settlement amounts differed depending on whether the sponsor warrants were still held by the SPAC's sponsor or its related parties or were instead held by public warrant holders. The SEC staff concluded that since the holder of the instrument is not an input into a fixed-for-fixed option pricing model (such as the Black-Scholes model), such a provision would preclude the sponsor warrants from being indexed to the entity's stock, and the warrants would therefore be classified as a liability.

In practice, we have observed a common set of provisions in sponsor warrants that might result in adjustments to the settlement amount of the warrants depending upon who holds the warrants and would therefore cause the sponsor warrants not to be indexed to the issuer's shares, resulting in liability classification for the sponsor warrants.

Under the first of these common provisions, following the initial business combination, the holders of sponsor warrants are entitled to receive the same amount and form of compensation to which the Class A shareholders would be entitled if certain specified events occur (such as a merger or reorganization). The holders of the sponsor warrants would receive this compensation based on the number of shares the holder of the warrant would have received if they had exercised their warrant on a net-share-settlement basis immediately preceding the qualifying transaction. However, if less than 70 percent of the consideration receivable by the shareholders is payable in the form of publicly traded common stock in a successor entity and if the warrant holder exercises the warrant within 30 days of the transaction, the warrant's settlement amount may be adjusted based, in part, on the fair value of the sponsor warrant determined by using the Black-Scholes option pricing model.

Under the second of these common provisions, the SPAC is generally unable to force the sponsor (or its related parties) to exercise sponsor warrants under any conditions; however, the SPAC may force holders of sponsor warrants, other than the sponsor (or its related parties), to exercise their warrants under certain conditions. Since sponsor warrants held by the sponsor or its related parties may have different settlement provisions than sponsor warrants held by other parties, the fair value of the warrants, as determined under the Black-Scholes model, may differ based on who holds the warrant.

The SEC staff concluded in their statement that sponsor warrants with these two common provisions fail the fixed-for-fixed criterion and are therefore accounted for as liabilities.

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.

Class A warrants issued by a SPAC may contain a variety of settlement provisions that must be carefully evaluated under the guidance in ASC 815-40-15-17C through 15-17I, including

- Antidilution adjustment provisions
- Down round adjustment provisions
- Discretionary adjustments to the settlement provisions made by the SPAC to benefit the Class A warrant holders
- A net share settlement option in the event of an early settlement that compensates the holders for the value of lost time

Regarding this last type of settlement provision, where the number of Class A shares issued to the holder of a Class A warrant is adjusted in the event of early settlement, determining whether the number of additional shares issued to the holder represents a reasonable amount of compensation for lost time value may be complex. (See an analysis of such a settlement provision in Example 19 in ASC 815-40-55-45 and 55-46.) Compensation for lost time value is generally considered reasonable if the monetary amount received by the warrant holder both (a) equals at least the intrinsic value of the Class A warrant on the early settlement date, and (b) does not exceed the fair value of the Class A warrant on the early settlement date. This analysis should be performed based on assumptions that are reasonable when the Class A warrant is initially issued based on the SPAC's specific facts and circumstances. Assumptions to consider may include factors in typical option pricing models, such as volatility, interest rates, and dividend yield.



Grant Thornton insights: Officer and director provisions in public warrants

We have observed in practice that the settlement amount could differ for certain public warrants depending upon whether the warrant is held by an officer or director of either the SPAC or the post-merger combined entity or by other parties. For example, if the SPAC forced net share settlement upon the exercise of its early redemption option, which would result in compensating the warrant holder for lost time value, the compensation received by warrant holders other than officers and directors would be determined using a table such as the one described in Example 19 in ASC 815-40-55-45 and 55-46. However, the compensation received by officers and directors would be determined based on the last sale price of the public warrants and might result in a difference from the compensation received by non-officers and non-directors.

As noted in the [statement](#) issued by the SEC staff on April 12, 2021, a difference in the settlement amount of the warrants related to the characteristics of the warrant holder would preclude equity classification.

Applying the equity classification guidance to Class A warrants

If an entity concludes that the Class A warrant is indexed to its own shares, it must then determine whether the Class A warrant complies with the equity classification guidance in ASC 815-40-25. In general, the equity classification guidance stipulates that an equity-linked contract does not qualify for equity classification if the issuer could be required to settle the contract in cash, regardless of the likelihood that circumstances requiring cash settlement would occur.

ASU 2020-06, *Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*, amended the equity classification guidance to make it more likely that equity-linked contracts will be classified in equity. Entities can early adopt the amendments in ASU 2020-06 in fiscal years, and in interim periods within fiscal years, beginning after December 15, 2020. The guidance in ASU 2020-06 cannot be adopted in an interim reporting period and should be adopted as of the beginning of the fiscal year of adoption. The following discussion contemplates the early adoption of the guidance in ASU 2020-06. Entities that do not early adopt the guidance in ASU 2020-06 need to consider criteria in the equity classification guidance that were either removed or revised under the amendments, the most prominent of which may be that an equity-linked contract can be settled in unregistered shares. Please see [NDS 2020-10](#), "ASU 2020-06 simplifies accounting for convertible instruments and contracts in entity's own equity," for further discussion of the amendments in ASU 2020-06.

The amended equity classification guidance indicates that an equity-linked contract is considered to be classified in equity under either of the following types of settlement arrangements:

- Physical settlement or net share settlement is required.
- Net cash settlement or settlement in shares is controlled by the issuer.

The equity classification guidance in ASC 815-40-25 also specifies certain additional conditions that must be met in order for an equity-linked contract to qualify for equity classification, as shown in Figure 4.2.

Figure 4.3: Criteria in the equity classification guidance

Condition for equity classification in ASC 815-40-25
Entity has sufficient authorized shares
Contract contains an explicit share limit
No required cash payment if entity fails to timely file with the SEC
No cash-settled top-off or make-whole provision
Settlement not explicitly required in registered shares

For further guidance on applying the equity classification guidance in ASC 815-40-25, please see [NDS 2020-10](#).

Whether Class A warrants meet the equity classification guidance depends upon the specific terms of the warrants issued by the SPAC. Some Class A warrants include provisions that allow the holder to net cash settle the warrant upon a change in control of the SPAC after the completion of a qualifying business combination, but before the warrant expires. Analyzing whether such provisions preclude equity classification requires judgment, and consultation with accounting advisers is encouraged.



Grant Thornton insights: Common tender offer provisions

The equity classification guidance in ASC 815-40-25 generally stipulates that a warrant does not qualify for equity classification if the issuer of the warrant could be required to settle the warrant for cash, regardless of the likelihood that circumstances would arise requiring cash settlement. However, the equity classification guidance provides an exception that would not preclude a warrant from equity classification if net cash settlement of the warrant is required only when holders of the equity shares underlying the warrant will also receive cash in exchange for their equity shares. The guidance in ASC 815-40-55-2 through 55-5 provides examples of such circumstances, including a change in control or other deemed liquidation event.

In its recent [statement](#), the SEC staff evaluated a fact pattern involving warrants issued by a SPAC that included a provision whereby all warrant holders would be entitled to receive cash for their warrants if a tender or exchange offer was made to the equity shareholders (which could be outside the control of the SPAC) and was accepted by holders of more than 50 percent of the outstanding equity shares of a single class of common stock. In this fact pattern, the post-merger combined entity had two classes of common shares—Class A and Class B. Both the sponsor warrants and public warrants contained the tender offer provision, and both classes of warrants could be exercised for Class A shares. However, the Class B shares controlled, and would continue to control, the post-merger combined entity, regardless of how many Class A shares were obtained by the tenderer in a qualifying tender offer. In this fact pattern, the SEC staff concluded that the tender offer provision would require the warrants to be classified as a liability because (1) 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, and (2) a qualifying tender offer that results in a cash settlement would not always lead to a change in control of the issuer.

Accordingly, we believe sponsor warrants or public warrants that have a tender offer provision similar to the one described in the SEC statement and that are either (1) issued by an entity with multiple classes of voting shares, or (2) are exercisable into a class of shares that does not control the entity, would be precluded from equity classification under the equity classification guidance in ASC 815-40.

For example, in addition to the scenario described above, we believe warrants with tender offer provisions similar to the one described in the SEC statement would be classified as liabilities in the following scenarios:

- A pre-merger SPAC has two classes of voting shares (Class A and Class B) and the tender offer provision pertains only to warrants exercisable into Class A shares.
- A post-merger combined entity has a single class of common shares into which the warrants are exercisable. However, the entity also has convertible preferred shares that are entitled to vote on an as-converted basis.

On the other hand, we believe that sponsor warrants or public warrants with a tender offer provision similar to the one described in the SEC statement, but for which (1) the issuer has only a single class of common shares into which the warrants are exercisable, and (2) only that class is entitled to vote on matters submitted to the entity's shareholders, would not be precluded from equity classification on the basis of the tender offer provision alone.

This is an area of significant complexity and judgment, and we encourage entities to consult with their accounting advisors.

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.



Classification of SPAC shares and warrants

At its IPO, SPAC issues Class A units via a public registered offering in exchange for cash. The Class A units are issued for \$10 per unit and include both a Class A share and a public warrant to purchase Class A share. Following the IPO, the holder of a Class A unit is permitted to trade the Class A share and public warrant independently, and exercise of the public warrant does not impact the terms of the Class A shares. Contemporaneously with the IPO, SPAC also issues sponsor warrants to SPAC's sponsor, who pays \$1.50 for each warrant. SPAC also has outstanding Class B shares, which provide the holders of the Class B shares with control over the SPAC's board of directors. Class B shares can be converted into Class A shares if SPAC consummates a qualifying business combination.

Key terms of SPAC shares and warrants

SPAC's Class A shares have the following key terms:

- No voting rights until a qualifying business combination occurs.
- Are redeemable for \$10 per share after SPAC files Form S-4 related to a qualifying business combination. The shares remain redeemable until the consummation of the qualifying business combination.
- Are redeemable for \$10 per share if SPAC does not complete a qualifying business combination within two years following its IPO date.

SPAC's public warrants and sponsor warrants have the following key terms:

- Can be exercised following the completion of a qualifying business combination for \$11.50 for one Class A share.
- Provide a term of five years.
- Contain provisions that adjust the exercise price of the warrant should SPAC issue Class A shares below then current market value.
- Can redeem public warrants for \$0.01 upon 30-day notice if SPAC's volume-weighted average price (VWAP) over 30 days reaches \$18. If SPAC exercises the call option, the holder of the warrant may net share settle the warrant. Sponsor warrants are not subject to this provision unless they are transferred to entities or individuals not designated as "permitted transferees."
- Can redeem both sponsor warrant and public warrant for \$0.10 upon 30-day notice if the fair value of the Class A shares is at least \$10, but less than \$18. If SPAC exercises the call option, the holder of the warrant may net share settle the warrant, with the number of Class A shares issued to the warrant holder determined pursuant to a table whose axes are share price and time to maturity.
- Contains a tender offer that entitles holders of both sponsor warrants and public warrants to receive cash for their warrants if a tender or exchange offer is made to the equity shareholders and if, following the tender offer, the maker of the tender offer holds more than 50 percent of the outstanding equity shares of a single class of common stock.
- Includes an "alternative issuance" feature with the following terms: If (1) there is a change-in-control of SPAC after the initial business combination in which less than 70 percent of the consideration received by the holders of the shares underlying the warrant consists of publicly traded shares in the successor entity, and (2) the warrant holders exercise their warrants within 30 days after the change-in-control is disclosed, then the strike price of both the public warrants and sponsor warrants would be adjusted so that the warrant's post-adjustment intrinsic value equals its pre-adjustment fair value. For public warrants, the fair value of the warrant for purposes of the adjustment is defined as a Capped American Call Black-Scholes value, whereas for sponsor warrants the fair value of the warrant for purposes of the adjustment is defined as an Uncapped American Call Black-Scholes value.

Unit of account

Because the holder of the Class A unit may separately trade the Class A share and public warrant, and because exercise of the warrant does not impact the terms of the share, the Class A share and public warrant are each freestanding financial instruments and are therefore analyzed independently.

Sponsor warrants are issued independently of other financial instruments and are therefore freestanding financial instruments.

Classification of Class A shares

Under the guidance in ASC 480, the redemption provisions of the Class A shares do not make the share mandatorily redeemable; therefore, the Class A shares are not liabilities under ASC 480. However, the Class A shares are probable of becoming redeemable and are therefore initially classified in temporary equity under the guidance in ASC 480-10-S99-3A.

If the Class A shares are not redeemed following a qualifying business combination and the attendant termination of their redemption provisions, the Class A shares would be reclassified into permanent equity.

Classification of Class B shares

Class B shares are not redeemable. While they are converted on a one-to-one basis into Class A shares, the conversion occurs only upon the completion of a qualifying business combination, at which time, the redemption rights of the Class A shares expire. Accordingly, Class B shares are classified in permanent equity.

Classification of warrants*Sponsor warrants*

The sponsor warrants are first analyzed under the guidance in ASC 480. Since the warrants cannot be exercised until a qualifying business combination is completed, at which point, the redemption provisions of the Class A shares would have been terminated, the Class A warrants do not represent an obligation to repurchase the SPAC's shares and therefore are not liabilities under ASC 480.

The sponsor warrants are next analyzed under the guidance in ASC 815-40, beginning with the indexation guidance. The sponsor warrants cannot be exercised until the completion of a qualifying business combination. Because this exercise contingency is not based on either of the conditions in ASC 815-40-15-7A (that is, either an observable market, other than the market for the issuer's shares, or an observable index, other than an index calculated or measured solely by reference to the issuer's own operations), the exercise contingency does not prevent the sponsor warrants from being considered indexed to SPAC's Class A shares.

The sponsor warrants are next analyzed to determine if their settlement terms meet the "fixed-for-fixed" criterion under ASC 815-40-15-7C. Under the "alternative issuance" provision, the fair value of the sponsor warrants used to calculate the adjustment to the exercise price is determined using the Uncapped American Call Black-Scholes value. However, if the sponsor warrant is transferred to an entity other than a "permitted transferee," the sponsor warrant becomes a public warrant, and the fair value of the public warrant, for purposes of determining the adjustment to the exercise price under the "alternative issuance" provision, is determined using the Capped American Call Black-Scholes value. Accordingly, the settlement amount of a sponsor warrant could change based on the characteristics of the warrant holder. Since the characteristics of the warrant holder is not an input to a fixed-for-fixed option pricing model, the sponsor warrants are classified as liabilities and are measured at fair value.

Public warrants

The public warrants are first analyzed under the guidance in ASC 480. Since the warrants cannot be exercised until a qualifying business combination is completed (at which point, the redemption provisions of the Class A shares would have been terminated), the public warrants do not represent an

obligation to repurchase the SPAC's shares and therefore are not classified as liabilities under ASC 480.

The public warrants are next analyzed under the guidance in ASC 815-40, beginning with the indexation guidance. The first step of the indexation guidance considers the warrants' two exercise contingencies: (1) they cannot be exercised until the completion of a qualifying business combination, and (2) SPAC may force early exercise of the public warrants if the VWAP of the Class A shares over 30 days is at least \$18. Because these exercise contingencies are not based on either of the conditions in ASC 815-40-15-7A, these contingencies do not prevent the public warrants from being considered indexed to SPAC's Class A shares.

The public warrants are next analyzed to determine if their settlement terms meet the "fixed-for-fixed" criterion. SPAC first analyzes the provision whereby the warrants' exercise price is adjusted for below-market value issuances of Class A shares and determines that such provisions constitute a standard antidilution provision, which does not violate the fixed-for-fixed criterion. SPAC then analyzes the \$0.10 call feature. SPAC carefully considers the table that prescribes the shares received by the holder in the event the holder elects net share settlement and determines that the purpose of the table is to compensate the warrant holder for lost time value. SPAC evaluates each settlement number in the table, and concludes that the table was designed, based on reasonable assumptions at the issuance date, to convey to the warrant holder a monetary value that is (a) at least equal to the intrinsic value of the warrant, and (b) not greater than the fair value of the warrant.

Next, SPAC analyzes whether the potential adjustment to the public warrant's exercise price under the "alternative issuance" provision would cause the public warrant to fail the "fixed-for-fixed" criterion. Because the adjustment is based on changes in the fair value of the public warrant and the fair value of the warrant is an input to a fixed-for-fixed option pricing model, the potential adjustment under the "alternative issuance" provision would not preclude a public warrant from being considered indexed to SPAC's Class A shares. Accordingly, SPAC concludes that the public warrants are indexed to the Class A shares.

Finally, SPAC evaluates each of the conditions for equity classification in ASC 815-40-25 for the public warrants. SPAC first analyzes the tender offer provision. Since the public warrants can be exercised into Class A shares and SPAC's Class B shares control SPAC, SPAC determines that not every qualifying tender offer under the tender offer provision would result in a change in control of SPAC, and that the public warrants must therefore be classified as liabilities.

Upon a qualifying business combination, the post-merger combined entity reassesses whether the tender offer provision would continue to require liability classification of the public warrants. The post-combination entity's public warrants would not be precluded from equity classification on the basis of the tender offer provision alone if, following the business combination, (1) there is only a single class of voting shares into which the public warrants are exercisable, and (2) only that class of shares is entitled to vote on matters submitted to the entity's shareholders.

Classification and allocation of proceeds

SPAC classifies the Class A shares within temporary equity and the sponsor warrants and public warrants as liabilities that are measured initially at fair value. SPAC allocates the proceeds received from issuing the Class A units between the shares and warrants based on the residual method, as the warrants are subsequently measured at fair value. Transaction costs are allocated between the Class A shares and warrants on the same basis.

4.2 Share-settled earnout arrangements

In negotiating a business combination, the SPAC and the private operating company will commonly agree to enter into an earnout arrangement with either the shareholders of the private operating company or with the sponsors of the SPAC. As discussed in Section 3.2, the first step in accounting for earnout arrangements is determining whether they represent share-based payment arrangements within the scope of ASC 718. The following discussion only applies to earnout arrangements that are not within the scope of ASC 718.

Generally, the settlement provisions in earnout arrangements in SPAC transactions are based on a combination of share price levels and the occurrence of certain liquidity events (such as a change in control or a sale of substantially all of the assets of the post-combination entity). Sometimes the arrangements are structured as a contract for contingently issuable shares. At other times, the arrangements are structured as legally outstanding shares subject to transfer restrictions that would be lifted upon either the occurrence of specified events or the passage of time. If the transfer restrictions are lifted only based on the occurrence of a contingent event, such as meeting a share price target, the shares may be forfeited to the combined entity if the specified events do not occur within a defined timeframe, which is referred to as an “earn back” arrangement. The following examples illustrate terms of earnout and earn back arrangements commonly seen in practice today.



Earnout arrangements

The shareholders of OpCo negotiate a business combination with SPAC that includes an earnout arrangement. Under the terms of the arrangement, the post-combination combined entity will issue up to a total of 6 million Class A shares to the precombination shareholders of OpCo if the combined entity's share price reaches certain levels or a qualifying liquidity event occurs within five years following the consummation of the business combination, as follows:

- Level 1: 2 million shares issued if the 40-day VWAP is \$20 or greater
- Level 2: 4 million shares issued if the 40-day VWAP is \$25 or greater
- Level 3: 6 million shares issued if the 40-day VWAP is \$30 or greater

If a qualifying liquidity event occurs, such as an acquisition by a single party of more than 50 percent of the combined entity's Class A shares or a sale of substantially all of combined entity's assets, the number of Class A shares issued under the earnout arrangement would be determined by comparing the price per share implied in the liquidity event to the corresponding Level 1, 2, or 3. If a qualifying liquidity event occurs and the price per share implied in the transaction is less than \$20, then the earnout arrangement would be terminated, and no shares would be issued.



Earn back arrangements

SPAC's sponsors agree to subject 3 million of their Class A shares in SPAC to an earn back arrangement. Under the terms of the arrangement, the SPAC sponsors are precluded from transferring the shares for a period of five years after the consummation of the business combination, unless certain

share price levels for the combined entity, as shown below, are achieved or a qualifying liquidity event occurs (that is, the restricted shares “vest”).

- Level 1: 1/3 of the earn back shares “vest” if the 40-day VWAP is \$20 or greater
- Level 2: 2/3 of the earn back shares “vest” if the 40-day VWAP is \$25 or greater
- Level 3: all of the earn back shares “vest” if the 40-day VWAP is \$30 or greater

If none of the share price levels are reached (or a qualifying liquidity event does not occur) by the end of the earn back arrangement, all of the shares subject to the earn back arrangement would be forfeited by the SPAC sponsors to the combined entity.

If a qualifying liquidity event occurs, such as an acquisition by a single party of more than 50 percent of the combined entity’s Class A shares or a sale of substantially all of the combined entity’s assets, the number of earn back shares that “vest” would be determined by comparing the price per share implied in the liquidity event to the corresponding Level 1, 2, or 3. If a qualifying liquidity event occurs and the price per share implied in the transaction is less than \$20, then the earn back arrangement would terminate and all of the earn back shares would be forfeited.

An earnout arrangement, such as those described above, is either classified in equity or as a liability pursuant to the guidance in ASC 480 and ASC 815-40, as illustrated in Figure 3.4.



Grant Thornton insights: Earnouts as equity-linked contracts

Earnout arrangements may be structured by issuing legally outstanding equity shares of the combined entity rather than contingently issuable shares. However, if the shares are forfeitable, such as with earn back arrangements, we believe that the earn back shares should be evaluated as an equity-linked contract issued on the combined entity’s shares rather than as outstanding shares, which means they would be subject to the classification guidance in both ASC 480 and ASC 815-40. We believe there is no substantive difference, for accounting purposes, between an issued share that is restricted and subject to forfeiture and an agreement to issue shares in the future if certain contingent events occur (such as meeting share price targets). In both cases, the shares should be accounted for as equity-linked contracts.

4.2.1 Freestanding financial instrument analysis

As with all equity-linked contracts, the first step in analyzing how to classify an earnout arrangement is to determine whether the arrangement represents one or multiple freestanding financial instruments (see Section 4.1.1 for a discussion on freestanding financial instrument analysis). In earnout arrangements with multiple settlement provisions, a key consideration in the freestanding financial instrument analysis is whether the settlement provisions are linked or independent of each other. This analysis is complex and depends upon the specific facts and circumstance of the earnout arrangement.

In the earnout and earn back arrangement examples above, the arrangements would be considered a single freestanding instrument because the settlement provisions are linked (that is, the beneficiary of the arrangement could not earn Level 2 shares without first earning Level 1 shares, and so forth).

4.2.2 Evaluating earnout arrangements under ASC 480

After an entity determines each freestanding financial instrument present in an equity-linked contract, the freestanding instrument(s) should be analyzed under ASC 480, as discussed in further detail in Section 4.1.3. In practice, most earnout arrangements are not classified as liabilities within the scope of ASC 480, for the following reasons:

- First, the earnout arrangements are generally not redeemable for cash or other assets.
- Second, since the earnout arrangement generally only arises after the consummation of a qualifying business combination, the redemption rights of the Class A shares would generally have been terminated. Therefore, such earnout arrangements generally would not constitute an obligation to repurchase the SPAC's equity shares.
- Finally, the earnout arrangements generally do not represent a conditional obligation to issue a variable number of shares based on any of the following:
 - A fixed monetary amount known at inception
 - Variations in something other than the fair value of the combined entity's equity shares
 - Variations inversely related to changes in the fair value of the combined entity's equity shares

4.2.3 Evaluating earnout arrangements under ASC 815-40

While ASC 815-40 applies to freestanding equity-linked contracts, it does not apply to freestanding financial instruments that are legal form shares. As such, entities should carefully consider whether earnout arrangements issued as legal form shares are within the scope of ASC 815-40. As noted above, we believe shares that are outstanding, but forfeitable, should be evaluated as equity-linked contracts.

If an earnout arrangement is an equity-linked contract, it must be evaluated under the guidance in ASC 815-40 to determine if the arrangement should be classified in equity or as a liability. The model for evaluating equity-linked contracts is described in more detail in Section 4.1.3.

Applying the indexation guidance to earnout arrangements

The indexation guidance in ASC 815-40-15 is a two-step model designed to determine whether the value received on an entity's own shares by the holder of a contract is indexed to changes in the value of the underlying shares (see Section 4.1.3).

Evaluating exercise contingencies

The first step in the indexation guidance addresses the impact of contingent exercise provisions in the contract (if any). According to ASC 815-40-15-7A, an exercise contingency in an equity-linked contract does not preclude equity classification if the exercise contingency is not based on either

- An observable market other than the market for the issuer's stock
- An observable index other than an index calculated or measured solely by reference to the issuer's own operations

In both of the earnout arrangement examples discussed above, there are two exercise contingencies: one related to the combined entity's share price and one related to a qualifying liquidity event. Neither of these exercise contingencies is prohibited by ASC 815-40-15-7A.

Evaluating settlement provisions

Next, the earnout arrangement's settlement provisions must be analyzed under the "fixed-for-fixed" criterion in ASC 815-40 (see Section 4.1.3). Provisions that impact the settlement of an equity-linked contract (in this case, the number of shares issued) do not violate the fixed-for-fixed criterion if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on the underlying equity shares.

Earnout arrangements may contain a variety of settlement provisions that require careful analysis under the guidance in ASC 815-40. This is an area of accounting complexity that requires judgment, and consultation with accounting advisers is encouraged.

In the earnout arrangement examples discussed above, there are two settlement provisions that affect the settlement amount: one related to the combined entity's share price over time and one related to the share price implied by a qualifying liquidity event. The settlement provision related to the combined entity's share price (VWAP) does not preclude the earnout arrangements from being considered indexed to the combined entity's shares, because the only input to this settlement provision is the volume-weighted average stock price, which is an input to a fixed-for-fixed option pricing model. Although a typical fixed-for-fixed option pricing model uses the spot price of an entity's shares, not an average price, Example 13 in ASC 815-40-55-38 indicates that the use of a volume-weighted average price does not preclude equity classification.

Settlement provisions related to a qualifying liquidity event require careful analysis to determine whether the factors impacting the settlement of the earnout arrangement are inputs to a fixed-for-fixed pricing model.

For the liquidity event settlement provision in the examples above, an entity may conclude that the settlement amount is solely impacted by share price, which is an input to a fixed-for-fixed pricing option model, if the price per share implied in the qualifying liquidity event is calculated by dividing the transaction consideration by a number of outstanding shares that includes shares that can be issued under the earnout arrangement. Accordingly, the earnout arrangement may be considered indexed to the combined entity's shares. If the price per share is not calculated based on a number of outstanding shares that includes the shares issuable under the earnout arrangement, then the earnout arrangement would not be considered indexed to the combined entity's shares.

If an entity concludes that the settlement amount is not solely impacted by share price but is also impacted by the occurrence (or non-occurrence) of a liquidity event, an entity would determine that the settlement provision violates the fixed-for-fixed criterion, because the occurrence (or non-occurrence) of a liquidity event is not an input to a fixed-for-fixed option pricing model. Under this interpretation, the earnout arrangement would be classified as a liability. Entities that apply such an interpretation do not need to evaluate whether the price per share implied in the qualifying liquidity event is calculated by including the shares issuable under the earnout contract or excluding them.

Applying the equity classification guidance to earnout arrangements

If an entity concludes that an earnout arrangement is indexed to its own shares, it must then determine whether the earnout arrangement complies with the equity classification guidance in ASC 815-40-25.

In general, the equity classification guidance stipulates that an equity-linked contract does not qualify for equity classification if the issuer could be required to settle the contract in cash, regardless of the likelihood that circumstances requiring cash settlement would occur. For further guidance on applying the equity classification guidance in ASC 815-40-25, see [NDS 2020-10](#).

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