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ACCOUNTING

Providing Clarity Around SEC Statement On SPAC Warrant Accounting

Find out why the recent guidance from the SEC on how SPAC warrants are classified requires careful consideration of the specific facts and circumstances for each entity and each contract.

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By Matt Smith & Petar Tomov.

Many companies have been working to interpret the U.S. Securities and Exchange Commission's (SEC) statement since its release in early April regarding the classification and accounting for warrants utilized by special purpose acquisition companies (SPACs). This is for good reason. The "Replacement of Securities upon Reorganization, etc." section in many SPAC warrant agreements contain a seemingly never-ending sentence that stretches three quarters of the page, and the associated accounting guidance is equally challenging to interpret. Therefore, the technical complexities have led many to understand that there are issues, but they're not always able to easily articulate exactly what these issues are.

Overview Of SPAC Warrants

SPACs, or "blank check" companies, generally issue at least two types of warrants on their road to an initial public offering (IPO):

1. ***Private Placement Warrants*** – Typically sold to sponsors to fund start-up costs; and
2. ***Public Warrants*** – Typically issued to third-party investors with shares held at the IPO stage as a way of enhancing the overall potential financial return to the IPO investors.

For illustrative purposes, a typical setup involves the SPAC issuing units to third-party investors at $10.00 per unit. Each unit generally contains both of the following:

- One Class A ordinary share (a "Class A share").
- A fraction of a warrant (typically in fractions of 1/2, 1/3, 1/4 or 1/5) to purchase one Class A share at an exercise price of $11.50 (a "public warrant").

Public warrants generally have a term of five years from the date of an acquisition and includes a redemption feature whereby the company can call the public warrants if the Class A share trades above a stated price level (e.g., $18.00) for 20 of 30 consecutive trading days. The redemption price is generally set to some nominal amount, effectively forcing the holder to exercise their warrant when called by the company.

SPAC sponsors generally purchase warrants ("private placement warrants") to acquire Class A shares at an exercise price of $11.50 per share. Those private

placement warrants are generally purchased at about $1.50 per warrant. They have substantially similar terms to the public warrants except for the following:

1. The private placement warrants contain cash and cashless exercise as opposed to the public warrants, which can only be exercised for cash other than in the case of certain redemptions; and
2. The private placement warrants don't include the redemption (forced exercise) features if the warrants are held by the SPAC sponsor or its permitted transferees.

Why Accounting Classification Matters

Warrants to buy publicly traded shares generally meet the definition of a derivative. However, ASC 815-10-15-74 provides for a derivative accounting scope exception for contracts issued or held by that reporting entity that are both:

1. Indexed to its own stock; and
2. Classified in stockholders' equity in its statement of financial position.

If a warrant agreement qualifies for the scope exception, it's recorded in equity initially with no subsequent accounting required. However, if the warrant agreement doesn't qualify for the scope exception, it must be marked to fair value at each reporting period with changes flowing through earnings.

Many SPACs have previously concluded that their warrants meet the scope exception provided in ASC 815-10-15-74; however, the recent SEC guidance indicates this conclusion may not be appropriate. This means many SPACs have inappropriately applied equity classification; thus, their historical financial statements have errors as they should've been recognizing their warrants as a derivative liability each reporting period with changes being recognized in earnings.

Issue #1: Indexation

To be classified as equity, a warrant must be considered "indexed" to an entity's own stock where a company applies a two-step approach: (1) it evaluates any contingent exercise provisions, and (2) it evaluates the settlement provisions. The SEC's concern specifically relates to the settlement provisions of SPAC warrants.

An instrument's settlement provisions must be evaluated to determine whether the instrument is indexed to the reporting entity's own stock. This guidance is often referred to as the "fixed-for-fixed" rule, which states that the warrant would be considered indexed to an entity's own stock if its settlement amount will be equal to

the difference between the fair value of a fixed number of shares and a fixed monetary amount. An example of this is a warrant that gives the counterparty a right to buy a fixed number of the shares for a fixed price. There's an exception to the "fixed-for-fixed" rule. This exception allows an instrument to be considered indexed to the reporting entity's own stock even if adjustments to the settlement amount can be made, provided those adjustments are based on standard inputs used to determine the value of a "fixed-for-fixed" forward or option on equity shares.

As noted above, the private placement warrants are generally not redeemable if the warrants are held by the SPAC sponsor or its permitted transferees. The SEC's statement notes this provision precludes equity classification for the private placement warrants because the holder of the instrument isn't an input into the pricing of a "fixed-for-fixed" option on equity shares.

Issue #2: Tender Offer Provisions

For an instrument to meet the second part of the derivative scope exception, it must be classified in stockholders' equity in its statement of financial position. This comes down to whether the entity controls the ability to settle the contract in shares. SPAC warrants generally contain a provision that allows their holders to receive cash in the event of a tender or exchange offer involving common shares underlying such warrants.

Under paragraph two of ASC 815-40-55, an event that causes a change in control of an entity isn't within the entity's control and, therefore, if a contract requires net cash settlement upon a change in control, the contract generally must be classified as an asset or a liability. However, the next paragraph provides an exception to this general principle whereby equity classification wouldn't be precluded if net cash settlement can only be triggered in circumstances in which the holders of the shares underlying the contract also would receive cash.

Many practitioners have historically viewed the exception noted above as being applicable because the holders of the warrants and the shares underlying the warrants both receive similar consideration on a pro rata basis regardless of the type of security. However, the SEC has concluded that this exception could only be applied if the event giving rise to the cash settlement would also cause a change of control of the entity. This may not be the case where an entity has two classes of common shares or the entity has other classes of securities that are entitled to vote. In these cases, a change in control may not occur and the exception noted above wouldn't be

applicable, thus not meeting the requirements to be classified in stockholders' equity in its statement of financial position.

What's Next?

While the SEC called out two specific issues in their statement, they reiterated that the evaluation of the accounting for warrants issued by a SPAC requires careful consideration of the specific facts and circumstances for each entity and each contract. Companies have been working with their valuation and financial reporting advisors to assess the impact to their historical financial statements and determine whether a restatement is required.

From a valuation perspective, the simplest approach is to use a close-form solution, like a Black-Scholes model. However, this will generally not be enough when determining the fair value of public SPAC warrants due to the redemption feature that's prevalent in these securities. As such, a more sophisticated, path-dependent model such as a Monte Carlo simulation is generally required.

Opportune is ready and able to assist with the evaluation of SPAC warrant classification, as well as any required valuation and materiality assessments. Contact one of our experts today to discuss your valuation and related advisory needs.

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