SEC Statement on Accounting Treatment of Warrants in SPAC Transactions Will Have Significant Near-Term Impact on Capital Markets

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SEC statement may require financial restatements and will pause SPAC market activity

Virtually every SPAC offering involves an offering of units composed of common stock and warrants to purchase common stock. Hundreds of companies, and all major accounting firms, have concluded that these warrants are equity securities and should be accorded equity treatment for accounting purposes. This week, the staff of the SEC issued a **statement** expressing a view that, despite the widespread practice to the contrary, most warrants issued in connection with a SPAC transaction should be accounted for as liabilities, rather than equity instruments, of the company. As a result, existing SPACs (and public companies that merged with SPACs) may need to restate their financial statements (and amend any corresponding periodic reports) if they conclude that the reclassification of existing warrants as liabilities would have a material impact on their financial statements.

While we do not expect that investors will view this accounting change as material, this pronouncement has already caused a pause in offerings by SPACs and former SPACs, as well as in the completion of SPAC mergers with private companies, as the SEC staff statement will not permit these offerings to progress until an analysis is complete and any required restatement is made. We are not aware of other situations in the recent past where the SEC staff, with no notice or comment, simply issued a proclamation that had such a significant chilling effect on capital markets activities.

Accounting Considerations

The statement by John Coates, the Acting Director of Corporation Finance, and Paul Munter, Acting Chief Accountant, identified two fact patterns involving warrants issued by a SPAC where the warrants should have been classified as liabilities rather than equity:

- *Not fully indexed to stock*: Under U.S. GAAP, a warrant must be indexed to the company's own shares in order to qualify as an equity instrument. A warrant with a variable settlement price would still be classified as equity if the variables are inputs to the fair value of a fixed-for-fixed forward or option on equity shares. Because the variables in certain warrants issued by SPACs are based on the characteristics of the warrant holder instead of such inputs (in other words, the terms of the sponsor warrants could be read to require a different formula than the public warrants), these warrants should be accounted for as a liability measured at fair value, with changes in fair value each period reported in earnings, according to the SEC.

- *Tender offer provisions do not provide cash to all shareholders*: In general, if an event that is not within the company's control could require net cash settlement, then the contract should be classified as an asset or a liability rather than as equity. An exception to this rule under U.S. GAAP is if the net cash settlement can only be triggered in circumstances in which all holders of the shares underlying the contract also would receive cash, such as in a change of control. However, where warrants issued by a SPAC include an event such as a qualifying cash tender offer (which could be outside the control of the company) that would entitle all warrant holders to cash, but only entitle certain of the holders of the underlying shares of common stock to cash, such warrants should be accounted for as a liability measured at fair value, with changes in fair value each period reported in earnings. Many SPACs include a clause that could be read to provide for warrant holders to receive cash when holders of a majority, but not all, shares of common stock receive cash.

Financial Restatements and Timing Considerations

As a practical matter, a review and possible reclassification of warrants has resulted in delays for both initial registration of SPACs and de-SPAC transactions. Every single one of the hundreds of SPACs and former SPACs, in consultation with its accountants, will need to review the specific terms of its issued warrants to determine whether the warrants were properly classified as equity or liabilities. Where any such warrants need to be reclassified, the SPAC must determine whether the impact of the error on its financial statements is material. For existing SPACs, a material misstatement would require a restatement of its previously issued financial statements (and an amendment of any Exchange Act periodic reports containing such financial statements) and the filing of Item 4.02, *Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review*, on Form 8-K. Any such restatements should also include revisions to the notes to the financial statements, as well as restated quarterly financial information and revisions to MD&A. As a result, effectiveness of any pending SEC submission by an existing or former SPAC will likely be delayed until such issues are resolved.

For SPACs that have pending submissions, if the SPAC determines the filings include such accounting errors but also determines that the accounting errors are not material, it may provide the staff with a written representation to that effect. The SEC, however, may disagree with the determination.

Lastly, the SEC's statement advises that SPACs should consider their obligation to maintain internal controls over financial reporting and disclosure controls and procedures to determine whether those controls are adequate. SPACs and their advisors should also assess whether prior disclosure on the evaluation of internal controls over financial reporting and disclosure controls and procedures, including disclosure on material weaknesses, needs to be revised in the amended filings.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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