

Technical Line

A closer look at accounting for financial instruments issued by SPACs

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What you need to know

- ▶ Merging with a special purpose acquisition company (SPAC) offers an alternative to an IPO for private companies that want to enter the public markets.
- ▶ Both SPACs and companies that are considering merging with them need to be aware of the accounting implications of the financial instruments issued by the SPACs.
- ▶ SPACs and combined companies resulting from SPAC mergers should consider an SEC staff statement on accounting for warrants issued by SPACs when evaluating the classification of warrants they issue.
- ▶ At the latest AICPA and CIMA Conference on Current SEC and PCAOB Developments, the SEC staff clarified its view that Class A shares issued by a SPAC that become redeemable upon its liquidation or merger should be presented outside of permanent equity.

Overview

There are typically four phases in the life cycle of a SPAC: SPAC formation, initial public offering (IPO) of the SPAC, SPAC merger with a private operating company (also referred to as a de-SPAC transaction) and post-merger as a combined public company. SPACs and companies that are considering merging with them need to be aware of the accounting implications of the following financial instruments that SPACs typically issue during their formation and IPO phases:

- ▶ Founder shares (e.g., Class B shares) that are issued to the sponsors of the SPAC and their affiliates at the time of the SPAC's formation

- ▶ Private placement warrants that are typically sold to sponsors of the SPAC and their affiliates to fund costs incurred by the SPAC
- ▶ Class A shares that are issued to public shareholders in the IPO
- ▶ Public warrants that are typically issued to IPO investors as part of a unit with Class A shares to enhance the investors' overall return

This publication addresses the issuer's accounting for these and other financial instruments such as earn-out arrangements and private investments in public equity that are often issued by SPACs. It supplements our Technical Line, [*Navigating the requirements for merging with a special purpose acquisition company.*](#)

Accounting considerations

SPAC formation



Upon formation, a SPAC is initially capitalized by a sponsor and its affiliates, who contribute nominal capital (usually \$25,000) in exchange for founder shares, typically in the form of Class B common stock, that are intended to make up 20% of the equity interests in the SPAC after the IPO. The sponsor and its affiliates may need to forfeit some shares to maintain their 20% interest if the underwriters do not fully exercise their overallotment options (see further discussion below).

To fund start-up costs and pay expenses associated with the IPO, such as the typical 2% underwriting fee, the SPAC sponsor and its affiliates may also purchase private placement warrants to acquire Class A shares at a strike price of \$11.50. Those private placement warrants are generally purchased for about \$1.50 per warrant.

Class B shares and private placement warrants

Unit of account

Because Class B shares acquired by the sponsor and its affiliates upon the SPAC's formation and private placement warrants are typically issued at different times, SPACs generally consider them freestanding financial instruments under the guidance in Accounting Standards Codification (ASC) 480.¹ That guidance defines a freestanding financial instrument as a financial instrument that is entered into (1) separately and apart from any of the entity's other financial instruments or equity transactions or (2) in conjunction with some other transaction and is legally detachable and separately exercisable.

Class B shares

Class B shares generally have voting rights and a conversion feature that automatically converts them into Class A shares upon an IPO. SPACs should consider whether these shares are compensatory and therefore in the scope of ASC 718.² We believe Class B shares generally are not subject to ASC 718 because there is no explicit service, performance or other condition that suggests that the shares are issued in exchange for goods or services to be used or consumed in the SPAC's operations.

Class B shares are equity in legal form and should only be classified as liabilities under ASC 480 if they:

- ▶ Are mandatorily redeemable for cash or other assets (ASC 480-10-25-4)
- ▶ Embody an unconditional obligation to issue a variable number of shares for which the monetary value is based solely or predominantly on (1) a fixed amount, (2) variations in something other than the fair value of the SPAC's equity shares or (3) variations that move in the opposite direction to changes in fair value of the SPAC's equity shares (ASC 480-10-25-14)

Because the Class B shares are not mandatorily redeemable and do not embody an obligation by the SPAC to issue a variable number of shares, the Class B shares are not classified as liabilities under ASC 480. Furthermore, because Class B shares are not redeemable, they are not required to be presented as "mezzanine" equity on the SPAC's balance sheet under the Securities and Exchange Commission (SEC) staff's guidance on redeemable equity securities cited in ASC 480-10-S99.³

While Class B shares generally do not meet the definition of a derivative in ASC 815,⁴ the existence of the conversion feature requires the SPAC to analyze the share (a hybrid instrument with an embedded conversion feature) to determine whether the conversion feature needs to be bifurcated and accounted for as a derivative. ASC 815-15-25-1 provides criteria that, if met, will result in an embedded derivative being bifurcated. In the case of the Class B shares, the conversion feature typically does not require bifurcation because the economic characteristics and risks of the conversion feature and those of the host contract, which is deemed an equity host, are clearly and closely related.

As discussed above, upon the SPAC's formation, the sponsor receives Class B shares that are intended to make up 20% of the equity interests in the SPAC after the IPO. The determination of the number of shares issued at formation necessary to maintain the sponsor's equity interest at 20% after the IPO assumes the underwriters will fully exercise certain overallotment options that the SPAC expects to grant to them. The overallotment options allow the underwriters to purchase a number of IPO units made up of one Class A share and one public warrant at the IPO price within a short period of time after the IPO.

If the underwriters do not fully exercise their overallotment options, the sponsor agrees to forfeit a number of shares so that its Class B shares will equal 20% of the equity interests in the SPAC after the IPO and after the exercise of any overallotment options. This forfeiture provision generally does not require accounting consideration until a forfeiture actually occurs. That is because such a forfeiture provision, which represents an embedded feature in the Class B shares, is deemed to have economic characteristics and risks that are clearly and closely related to the nature of the equity host in the Class B shares. Therefore, bifurcation and derivative accounting are not required.

Private placement warrants

SPACs may issue private placement warrants to the sponsor and affiliates during the formation phase or in connection with the IPO to raise working capital, including funding to cover the cost of the IPO (such as the 2% underwriting fee, which is a significant component of the SPAC's expenses).

A SPAC may also issue private placement warrants to its employees or third-party service providers in exchange for goods or services provided to the SPAC. These warrants would be in the scope of ASC 718 since they would be considered compensation or payment for goods or services. Warrants that are not accounted for under ASC 718 should be assessed under ASC 480 and ASC 815-40⁵ to determine whether they should be classified as equity or liabilities. See the ***SPAC warrants, including public warrants*** section below for further discussion.

Class B shares
are generally
classified in equity
in their entirety.

SPAC IPO



In its IPO, a SPAC typically offers investors units comprising one Class A share and one public warrant for \$10 per unit. Public warrants typically are issued with a strike price of \$11.50 and become exercisable shortly after the SPAC acquires an operating company.

Unit of account

Although the Class A shares and public warrants are issued as a unit to investors, they can be traded separately soon after the IPO. Because they are both legally detachable and separately exercisable, the instruments are considered “freestanding” under the definition of a freestanding financial instrument in ASC 480.

SPACs would then consider the guidance in ASC 815-10-15-9 to determine whether the economic substance of these freestanding financial instruments suggests that accounting for them on a combined basis (i.e., one unit of account) is more appropriate. That guidance provides indicators to be considered in determining whether freestanding financial instruments should be viewed as a unit and requires combining freestanding financial instruments in some cases to prevent circumvention of the derivative guidance.

Indicators that freestanding financial instruments should be combined			
Indicator 1	Indicator 2	Indicator 3	Indicator 4
The transactions were entered into contemporaneously and in contemplation of one another.	The transactions were executed with the same counterparty (or structured through an intermediary).	The transactions relate to the same risk.	There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

SPACs generally conclude that they should treat Class A shares and public warrants as separate units of account because there is a substantive business purpose for issuing the public warrants concurrently with the Class A shares. That is, the public warrants are intended to give the holders the opportunity to invest in additional equity interests of the combined company once the SPAC merges with an operating company.

Allocation of proceeds

A SPAC allocates the proceeds it receives for each unit (i.e., \$10 per unit) between the two instruments. We understand that the staff of the Financial Accounting Standards Board (FASB) and the staff of the SEC both believe that a freestanding instrument issued concurrently with other instruments should be initially measured at fair value if it is required to be subsequently measured at fair value under US GAAP, with the residual proceeds from the transaction

allocated to remaining instruments. In this case, the Class A shares are classified in equity (see discussion below). Therefore, the subsequent measurement of the public warrants determines how the proceeds should be allocated:

- ▶ If the public warrants are classified as liabilities that must be measured at fair value at each reporting period with changes in fair value recognized in earnings, proceeds would be allocated to the public warrants equal to their fair value and the residual would be allocated to the Class A shares.
- ▶ If the public warrants are classified as equity, the relative fair value method would be used to allocate the proceeds. It requires an entity to allocate a portion of the proceeds based on the proportion of an instrument's fair value to the sum of the fair values of all the instruments covered in the allocation.

Class A shares

In general, SPACs do not issue Class A shares to receive goods or services; therefore, Class A shares are generally not considered share-based payment arrangements that would be subject to ASC 718. Class A shares that are not accounted for under ASC 718 should be assessed under ASC 480 and ASC 815-40 to determine whether they should be classified as equity or liabilities.

Classification

Distinguishing liabilities from equity (ASC 480)

Because the legal form of Class A shares is equity, they should be classified as liabilities under ASC 480 only if they:

- ▶ Are mandatorily redeemable for cash or other assets (ASC 480-10-25-4)
- ▶ Embody an unconditional obligation to issue a variable number of shares for which the monetary value is based solely or predominantly on (1) a fixed amount, (2) variations in something other than the fair value of the SPAC's equity shares or (3) variations that move in the opposite direction to changes in fair value of the SPAC's equity shares (ASC 480-10-25-14)

The Class A shares generally are not liabilities because they are not mandatorily redeemable and don't represent an unconditional obligation to issue a variable number of equity shares of the SPAC with the characteristics described in ASC 480-10-25-14. As a result, they are generally classified in equity.

Embedded derivatives (ASC 815)

Freestanding financial instruments that are not in the scope of ASC 480 should be evaluated pursuant to ASC 815. Those instruments may either be derivatives themselves or may contain embedded features that would be derivatives if they were freestanding.

Class A shares do not meet the definition of a derivative because they require an initial investment in cash (or other assets) equal to their fair value at inception (that is, the "no initial net investment" criterion for a derivative is not met). However, because the shares typically contain a redemption feature that allows a public shareholder to redeem its shares before the merger with an operating company or when the SPAC dissolves if it doesn't complete a merger, the shares would be viewed as hybrid instruments that must be analyzed to determine whether the redemption feature needs to be bifurcated and accounted for as a derivative.

This analysis starts with the assessment of whether a Class A share contains a debt host or an equity host. ASC 815-15-25-17A requires an issuer or investor to consider the economic characteristics and risks of a hybrid instrument issued in the form of a share, including all of its stated and implied substantive terms and features, to determine whether the nature of the host contract in the share is more akin to debt or to equity.

The table below presents several key features that are common in stock and whether those terms and features are, by their nature, debt-like or equity-like. Each term and feature of the hybrid instrument should be considered. Once a determination is made about whether a feature is debt-like or equity-like, the feature should be weighted based on the relevant facts and circumstances and, after considering the weighting of all terms and features, the nature of the host contract should be determined.

Feature	Equity-like ←————→ Debt-like			
<i>Redemption</i>	Perpetual	Puttable (at holder's option) on contingent event	Puttable (at holder's option) with passage of time	Mandatorily redeemable
<i>Dividends</i>	Cumulative participating (and presumably noncumulative participating)		Noncumulative fixed rate (and presumably indexed variable rate)	Cumulative fixed rate (and presumably cumulative indexed variable rate)
<i>Voting rights</i>	Votes with common on as-converted basis	Votes with common on as-converted basis on specific matters	Votes only on matters related to specific instrument	Nonvoting
<i>Covenants</i>	No provisions that are substantively protective covenants		Includes provisions that are substantively protective covenants	
<i>Conversion rights</i>	Mandatorily convertible	Optionally convertible	Not convertible	

Before the merger with an operating company, public investors of SPACs generally do not receive dividends or have opportunities to vote on key decisions of the SPAC. This is because the sole purpose of the SPAC is to identify a target and merge with that entity, and this is a responsibility of the sponsors. Also, the cash raised in the IPO is typically put in a trust to fund the acquisition and/or the redemption of Class A shares by public shareholders who elect to do so upon the merger. Given these facts and the existence of the redemption option, some view the nature of the host contract in the Class A shares to be debt.

However, others view the nature of the host contract in the Class A shares to be equity, despite the redemption provision. That's because public investors in a SPAC buy the shares to capture the upside potential of a successful business combination with a target operating company. This outcome provides the most upside to investors and aligns with the sole business purpose of the SPAC (i.e., merging with a target).

If the SPAC concludes that the host instrument is equity-like, the redemption feature is not clearly and closely related to the host. Because the redemption feature meets the definition of a derivative (i.e., underlying, notional amount, no initial net investment, net settlement), the SPAC would need to analyze whether the redemption feature meets the derivative scope exception in ASC 815-10-15-74(a). However, the redemption amount is generally determined based on a formula, which includes inputs such as taxes and the number of outstanding shares at the time of redemption. Because these inputs are not inputs to the fair value of a fixed-for-fixed option or forward on equity shares, the redemption amount is not considered indexed to the SPAC's own equity; therefore, the SPAC cannot apply the equity scope exception in ASC 815-10-15-74(a). This would generally result in the redemption feature being bifurcated from the equity host contract and accounted for as a derivative.

If the SPAC concludes that the host is debt-like because of the redemption feature, it would apply the four-step test in ASC 815-15-25-42 to determine whether calls or puts that can accelerate the repayment of principal on debt are considered to be clearly and closely related

to the debt host contract. Most SPACs that conclude that the host is debt-like also conclude that they don't have to bifurcate the redemption option and they can treat the Class A share as one unit of account.

Classification and measurement of redeemable securities (ASC 480-10-S99-3A)

Since a SPAC is an SEC registrant, it must consider the SEC staff's guidance in ASC 480-10-S99-3A on redeemable equity securities. Because the Class A shares contain redemption rights that make them certain to become redeemable by the holder and no exceptions in ASC 480-10-S99-3A apply, the Class A shares must be classified in temporary (i.e., mezzanine) equity in the SPAC's financial statements and are subject to the subsequent measurement guidance in ASC 480-10-S99-3A. Once the SPAC successfully completes a merger with a target, the redemption features of the Class A shares terminate. At that time, the Class A share should be reclassified into permanent equity of the combined company.

The governing documents of SPACs typically do not permit a redemption of the Class A shares if it would cause the company's net tangible assets to decline below a certain threshold (i.e., less than \$5 million). Some SPACs classified a portion of the Class A shares in permanent equity, partially because they viewed the unit of account to be the pool of the Class A shares, not the individual share. At the latest AICPA and CIMA Conference on Current SEC and PCAOB Developments,⁶ the SEC staff clarified its view that each share should be presented outside of permanent equity and said that it disagrees with the view that the pool of the class of shares is the unit of account rather than each individual share. An entity should consider the staff's view when evaluating whether to classify its Class A shares in temporary or permanent equity.

Initial measurement

The SEC staff guidance cited in ASC 480-10-S99-3A says the initial carrying value of a redeemable equity security classified in temporary equity should generally be its issuance date fair value. However, if a redeemable equity instrument is issued with other freestanding instruments, the initial carrying value of the amount classified in temporary equity should be the redeemable equity instrument's allocated proceeds.

As discussed above, because the Class A shares are issued in units that also contain warrants, the SPAC must allocate proceeds between the two instruments. As a result, the initial carrying amount of a Class A share in temporary equity is below the unit price of \$10. If an embedded feature requires bifurcation from a Class A share, the bifurcated feature is allocated its full fair value and the residual would be allocated to the Class A share host contract, which would further reduce the initial carrying value below the unit price of \$10.

Subsequent measurement

ASC 480-10-S99-3A says that if the instrument is not currently redeemable but it is probable that the instrument will become redeemable (e.g., the instrument can be redeemed upon a contingent event that is probable of occurring, the instrument is redeemable upon passage of time), the instrument should be remeasured pursuant to one of the following methods:

Methods	Description
Method 1	Changes in the redemption value are accreted over the period from the date of issuance to the earliest redemption date.
Method 2	Changes in the redemption value are recognized immediately as if the redemption were to occur at the end of the reporting date based on the conditions that exist as of that date.

Before a merger with an operating company, a SPAC generally presents its Class A shares as "mezzanine" equity in its financial statements.

Because the Class A shares contain redemption rights that make them certain to become redeemable by the holder, the probable threshold is met. Therefore, the Class A shares are subject to the subsequent measurement guidance in ASC 480-10-S99-3A. The SPAC can choose to accrete the Class A shares from their initial carrying amount to the \$10 redemption value over the period from the IPO date to the redemption date (i.e., the merger transaction date) or immediately.

Earnings per share (EPS) considerations

Subsequent measurement adjustments recorded pursuant to ASC 480-10-S99-3A related to redeemable instruments are treated in the same manner as dividends on nonredeemable stock and may affect income available to common shareholders (i.e., the EPS numerator). The manner in which subsequent adjustments affect EPS depends on whether the redeemable securities are common stock or preferred stock, and if they are common stock (most common in SPAC structures), whether the redemption value is at fair value or at an amount other than fair value.

Specifically, if the holders of redeemable common stock have a contractual right to receive a redemption amount other than fair value (e.g., a fixed amount) of the issuer's common shares, those shareholders have, in substance, received a different distribution than other holders of common stock (i.e., a preferential dividend). Paragraph 21 of ASC 480-10-S99-3A says a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights is required to apply the two-class method to calculate EPS under ASC 260.⁷

Generally, Class A shares are redeemable at a price equal to the amount deposited in the trust account held by the SPAC (i.e., the gross proceeds from the IPO), plus any interest earned on the amounts in the trust account, reduced by the amount used by the SPAC for taxes and other operational expenses. This redemption price would generally not be considered a redemption at fair value. Accordingly, the adjustments to the carrying amount should be reflected in EPS using the two-class method.

The SEC staff believes that,⁸ when common stock is redeemable at something other than fair value, there are two acceptable approaches for allocating earnings between the different classes of shareholders under the two-class method:

Approaches to apply the two-class method	
Approach 1	Approach 2
Treat the entire periodic adjustment to the security's carrying amount like a dividend	Treat only the portion of the periodic adjustment to the security's carrying amount that reflects a redemption in excess of fair value like a dividend

An entity in this situation needs to make an accounting policy election about which approach to use. The entity would then need to apply the approach consistently and disclose it as an accounting policy in the notes to the financial statements. For further discussion on the effect of redeemable securities on EPS, see section 3.2.2 of our FRD publication, [Earnings per share](#).

SPAC warrants, including public warrants

The private placement warrants and public warrants generally include the following key terms:

- ▶ *Underlying.* Each warrant is exercisable into one Class A share.
- ▶ *Strike price.* The price at which holders can exercise their warrants to purchase shares is typically \$11.50 (15% above the \$10 IPO price), with anti-dilution adjustments for splits, stock and cash dividends.
- ▶ *Exercise contingencies.* The warrants become exercisable on the later of 30 days after the SPAC merger transaction and the 12-month anniversary of the SPAC IPO. The warrants expire if a SPAC merger is not consummated.
- ▶ *Term.* The term is typically five years.
- ▶ *Settlement provisions.* The warrants can be physically settled upon exercise, meaning a holder delivers \$11.50 in cash in exchange for one share of Class A stock for each warrant. In certain circumstances, the holder can be required to settle on a cashless basis, meaning the holder receives a number of shares equal to either the intrinsic value or the fair value of the warrant and doesn't pay any cash.
- ▶ *Tender offer provisions.* If a qualifying cash tender offer is made to the Class A shareholders and accepted by holders of a majority of the outstanding Class A shares, all warrant holders are entitled to receive cash for their warrants.

While most of the terms of private placement warrants are identical to those of public warrants, there are several important differences that can affect the classification of the instruments by both the SPAC and the combined company as well as the entities' earnings.

Differences between private placement and public warrants

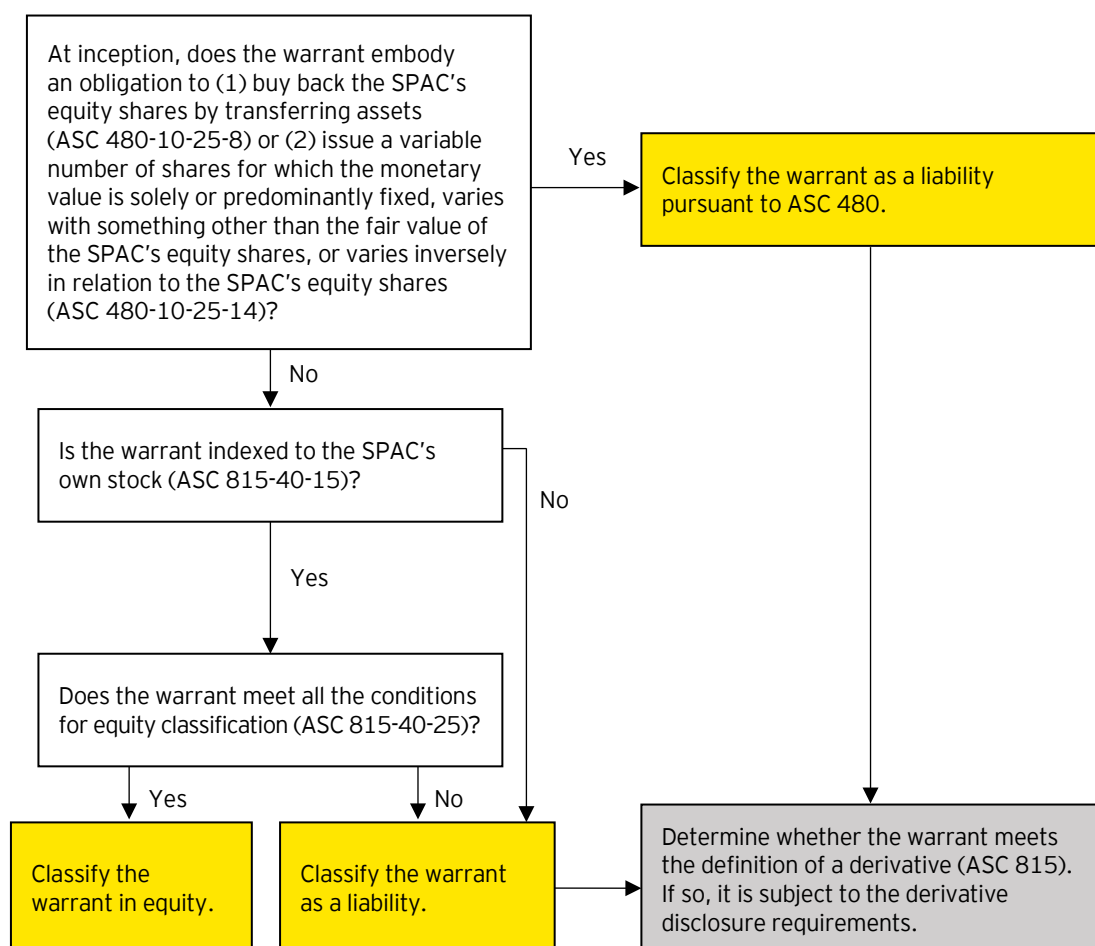
Adjustments to the strike price are calculated differently – While the strike price of both types of warrants is often reduced when there is a change in control of the SPAC and less than 70% of the consideration received by SPAC shareholders in that transaction is stock listed on an exchange, the adjustments are calculated differently.

Holders of public warrants effectively can be forced to exercise them in certain situations – The SPAC can redeem public warrants for \$0.01 per warrant, effectively forcing holders to exercise them, if the warrants are exercisable and the Class A shares trade above \$18 per share for a period of time. Private placement warrants are typically not subject to such a redemption.

Holders of public warrants effectively can be forced to exercise them on a cashless basis – If public warrants are exercisable and the Class A shares trade at or above \$10 per share, the SPAC can redeem the public warrants for \$0.10 per warrant. In this situation, the holders' only alternative is to exercise and settle the warrants on a cashless basis and receive a number of Class A shares based on a "make-whole" table. Private placement warrants are typically not subject to such a redemption.

Private placement warrants can become public warrants – Private placement warrants become public warrants if they are transferred to a party that is not the sponsor or an affiliate of the sponsor.

The following flowchart summarizes the evaluation for classifying SPAC warrants that are not accounted for under ASC 718. It assumes the entity has already adopted Accounting Standards Update 2020-06, *Debt – Debt with Conversion and Other Options (Subtopic 470-20)* and *Derivatives and Hedging – Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*.



Distinguishing liabilities from equity (ASC 480)

Private placement warrants generally meet the definition of a freestanding financial instrument because they are issued separately and apart from other instruments. Likewise, public warrants are considered freestanding because they can be separately traded soon after the IPO, even though they are issued as a unit with the Class A shares in the IPO. Consequently, both types of SPAC warrants should first be analyzed under the guidance in ASC 480.

ASC 480 provides guidance for how an issuer classifies and measures in its statement of financial position certain freestanding equity-linked financial instruments, including forwards, options and warrants. Any financial instrument, other than an outstanding share, that embodies, or is indexed to, an obligation to repurchase an issuer's shares that may require the issuer to transfer assets (e.g., cash) is a liability (or sometimes an asset) pursuant to ASC 480-10-25-8. In addition, contracts that embody an obligation that must or may be settled by issuing a variable number of shares are liabilities pursuant to ASC 480-10-25-14 if the monetary value of the obligation does not expose the holder to risks and rewards similar to those of an owner.

If a warrant is exercisable into shares that are redeemable, or the warrant itself is redeemable, for cash or other assets, it would be classified as a liability, pursuant to ASC 480-10-25-8. While the SPAC warrants are not redeemable by the holders, as discussed above, the Class A shares underlying the warrants are redeemable by the holder for cash. As a result, the warrants would be classified as liabilities if they are exercisable before the merger (which is typically not the case). That's because the holder of the warrant would be receiving a Class A share that is redeemable at the holder's option. However, if the warrants can only be exercised after the merger transaction (when the Class A shares are no longer redeemable by the holders), the warrants would not be classified as liabilities under ASC 480-10-25-8 because the Class A shares received by the holder upon exercise of the warrants are not redeemable.

If the warrants are not liabilities pursuant to ASC 480-10-25-8, the SPAC generally would then conclude that the warrants are not liabilities under ASC 480-10-25-14 either. That's because the SPAC warrants generally do not represent an obligation to issue a variable number of shares whose monetary value is based solely or predominantly on (1) a fixed amount, (2) variations in something other than the fair value of the Class A shares or (3) variations that move in the opposite direction to changes in fair value of the Class A shares.

Contracts in an entity's own equity (ASC 815-40)

SPAC warrants that are not in the scope of ASC 480 should be evaluated under the guidance in ASC 815-40 to determine whether they should be classified as liabilities or equity. ASC 815-40 applies to both (1) instruments that meet the definition of a derivative that are being evaluated to determine whether the exception to derivative accounting pursuant to ASC 815-10-15-74(a) applies and (2) instruments that do not meet the definition of a derivative to determine their appropriate classification.

ASC 815-40 states that contracts should be classified as equity instruments (and not as an asset or liability) if they are both:

- ▶ Indexed to the entity's own stock (ASC 815-40-15)
- ▶ Classified in stockholders' equity in the entity's statement of financial position (ASC 815-40-25)

The indexation guidance (ASC 815-40-15)

ASC 815-40-15 outlines a two-step evaluation to determine whether an instrument (or embedded feature) is indexed to the issuer's own stock.

Evaluations	
Step 1: Evaluate any exercise contingencies	Exercise contingencies based on an observable market or index that is not based on the issuer's stock or operations preclude an instrument from being considered indexed to an entity's own stock.
Step 2: Evaluate whether each settlement provision is consistent with a fixed-for-fixed equity instrument	Any settlement amount not equal to the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount precludes an instrument from being considered indexed to an entity's own stock (with certain exceptions for variables that would be inputs to the valuation model for a fixed-for-fixed forward or option contract).

Settlement amounts for warrants can differ depending on who holds them.

The exercise contingencies included in SPAC warrants generally do not preclude the warrants from being considered indexed to the entity's own stock under Step 1. However, SPAC warrants often contain adjustment provisions that change the number of shares issuable upon exercise or the strike price of the warrants. Therefore, Step 2 of the indexation guidance should be carefully evaluated to determine whether any of these adjustment provisions would preclude the warrants from being considered indexed to the SPAC's own stock.

Step 2 of the indexation guidance is premised on a basic principle that the settlement amount should be based on an exchange of a fixed number of shares for a fixed amount of consideration. While there are exceptions to this general rule, the exceptions are limited to adjustments that change the settlement amount based only on variables that would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares. In addition, certain adjustments that are designed to compensate one of the parties to the instrument for changes in fair value that are not incorporated into a standard pricing model should not preclude a conclusion that an instrument is indexed to the company's own stock.

Common adjustment provisions in the warrants include the following:

- ▶ Anti-dilution adjustments for splits, stock and cash dividends
- ▶ Adjustments to the number of Class A shares issuable upon exercise, in order to protect the holder from a loss of time value
- ▶ Adjustments to the exercise price based on a warrant value using the Black-Scholes model upon certain tender or exchange offers for the SPAC's outstanding common stock
- ▶ Cap provisions that limit the number of Class A shares issuable upon certain "cashless" exercises
- ▶ Changes in the terms of private placement warrants upon a transfer to a non-affiliated party

The discussion below describes the analysis under the indexation guidance of some of the common adjustment provisions in warrants issued by SPACs. The list is not all-inclusive. SPACs should carefully review and analyze their warrant agreements to make sure all adjustment provisions, regardless of the likelihood that an adjustment would be triggered, are appropriately evaluated pursuant to the indexation guidance in ASC 815-40-15.

Adjustment provisions that generally do not preclude SPAC warrants from being 'indexed'

Common adjustment provisions in warrant agreements that generally would not preclude the warrants from being considered indexed to the SPAC's own stock include:

Anti-dilution adjustments. If these provisions are designed to adjust the strike price of the warrants or the number of shares to be issued to offset the resulting dilution upon events such as splits, stock dividends or cash dividends, they generally do not preclude the SPAC warrants from being considered indexed to the SPAC's own stock.

Redemption features. SPAC warrants often contain redemption features that, if exercised, change the settlement amount of the warrants. These features generally do not preclude warrants from being indexed to the SPAC's stock. The table below describes the analysis a SPAC would perform for each redemption feature.

Redemption feature	Analysis
<p><i>\$0.01 redemption feature.</i> The SPAC can redeem the warrants for \$0.01 per warrant when the Class A share price exceeds \$18 per share for a period of time. The holder is given an opportunity during the redemption period (typically 30 days) to exercise the warrants. This redemption feature effectively forces the warrant holders to exercise the warrants (rather than receive the nominal redemption amount of \$0.01 per warrant) and, therefore, caps the return to the holders.</p>	<p>Step 1 – The feature that allows the SPAC to redeem the warrants for \$0.01 per warrant when the Class A share price exceeds \$18 per share is considered an exercise contingency. It is not an observable market or an observable index that is unrelated to the SPAC, so this feature does not preclude the warrants from being considered indexed to the SPAC’s own stock under Step 1. Proceed to Step 2.</p> <p>Step 2 – Once the exercise contingency is triggered, the settlement amount would equal the difference between the fair value of a fixed number of Class A shares underlying the warrants and a fixed strike price (\$11.50 per share). Therefore, the warrants would be considered indexed to the SPAC’s own stock.</p>
<p><i>\$0.10 redemption feature.</i> The SPAC can redeem the warrants for \$0.10 per warrant when the underlying share price equals or exceeds \$10 per share. During the redemption period, a holder can exercise its warrants on a “cashless basis” and receive a number of shares determined by using a “make-whole” table in the warrant agreement that is designed to compensate holders for the loss of time value in the warrants for any settlement that occurs when the Class A shares trade below \$18.</p>	<p>Step 1 – The feature that allows the SPAC to redeem the warrants for \$0.10 per warrant when the Class A share price equals or exceeds \$10 per share is considered an exercise contingency. It is not an observable market or an observable index that is unrelated to the SPAC, so the feature does not preclude the warrants from being considered indexed to the entity’s own stock under Step 1. Proceed to Step 2.</p> <p>Step 2 – For the warrants not to be precluded from being classified in equity (i.e., not to fail Step 2), the “make-whole” table in the warrants should generally present the following characteristics:</p> <ul style="list-style-type: none"> ▶ The number of shares in the “make-whole” table is determined by reference to the table with axes of stock price and time. ▶ The table is designed to compensate the holders for intrinsic value plus lost time value determined by assuming no change in relevant pricing inputs (other than stock price and time) and using reasonable assumptions (e.g., volatility, dividends, interest rates) known at the issuance date of the warrants. This determination would require an understanding and evaluation of the appropriateness of the pricing model used to determine the time value.

Redemption feature	Analysis
	Consistent with the example in ASC 815-40-55-45 through 55-46, a “make-whole” provision with these characteristics generally does not preclude SPAC warrants from being considered indexed to the company’s own stock. That is because the aggregate fair value of the shares received approximates the fair value of the warrants exercised.

Adjustment provisions that would preclude SPAC warrants from being 'indexed'

The staffs of the SEC’s Division of Corporation Finance and the Office of the Chief Accountant issued a joint statement⁹ in April 2021 that highlighted the potential accounting implications of certain terms that are common in warrants issued by SPACs.

The joint statement provided the staffs’ views on common features included in these warrants and their conclusion that certain features require SPACs to classify the warrants as liabilities rather than as equity. After the statement was issued, many SPACs and combined companies restated their financial statements because they historically had reported these warrants in equity. SPACs and combined companies resulting from SPAC mergers should consider this statement when evaluating the classification of warrants issued before and after a merger.

SPACs and combined companies should consider the SEC staff statement when evaluating the classification of their warrants.



SEC staff statement – indexation considerations

The SEC staff said the warrants it reviewed included provisions that could change the settlement amounts depending on the characteristics of the warrant holder (e.g., whether the warrant holder is a SPAC sponsor or an unaffiliated third party). Because the holder of an instrument is not an input to an option pricing model, the SEC staff concluded that the warrants it reviewed couldn’t be considered indexed to the entity’s own stock under the indexation guidance and, therefore, should be classified as liabilities measured at fair value, with changes in fair value each period recognized in earnings.

The tables below describe common adjustment provisions that generally preclude SPAC warrants from being considered indexed to the SPAC’s own stock, along with examples of how the provisions are described in a SPAC warrant agreement.

\$0.01 redemption feature	
Adjustment provision (affects private placement warrants only)	Analysis
If private placement warrants are not subject to the \$0.01 redemption feature discussed above but will be when those warrants are transferred to a third party not affiliated with the sponsor (often referred to as a non-permitted transferee) and become public warrants, the calculation of the settlement amount changes.	Because the settlement amount depends solely on who holds the instrument, and this is not an input to the fair value of a fixed-for-fixed option or forward on equity shares, this provision would cause the warrants to fail Step 2 of the indexation guidance. As a result, the private placement warrants would be classified as liabilities.

Example of provision in a SPAC warrant agreement

2.6. The Private Placement Warrants shall be identical to the Public Warrants, except that so long as they are held by the Sponsor or any of its Permitted Transferees (as defined below) the Private Placement Warrants: (i) may be exercised for cash or on a “cashless basis,” pursuant to subsection 3.3.1(c) hereof, (ii) including the Ordinary Shares issuable upon exercise of the Private Placement Warrants, may not be transferred, assigned or sold until thirty (30) days after the completion by the Company of an initial Business Combination and (iii) shall not be redeemable by the Company pursuant to Section 6.1 hereof; provided, however, that in the case of (ii), the Private Placement Warrants and any Ordinary Shares issued upon exercise of the Private Placement Warrants may be transferred by the holders thereof ...

6.1. Subject to Section 6.5 hereof, not less than all of the outstanding Warrants may be redeemed, at the option of the Company, at any time during the Exercise Period, at the office of the Warrant Agent, upon notice to the Registered Holders of the Warrants, as described in Section 6.3 below, at a Redemption Price of \$0.01 per Warrant, provided that (a) the Reference Value equals or exceeds \$18.00 per share (subject to adjustment in compliance with Section 4 hereof) and (b) there is an effective registration statement covering the issuance of the Ordinary Shares issuable upon exercise of the Warrants, and a current prospectus relating thereto, available throughout the 30-day Redemption Period (as defined in Section 6.3 below) or the Company has elected to require the exercise of the Warrants on a “cashless basis” pursuant to subsection 3.3.1.

Different settlement amounts upon certain mergers for public vs. private warrants

Adjustment provision (affects private placement warrants only)	Analysis
<p>The strike price of a private placement warrant may be adjusted upon certain change in control transactions. For example, if the SPAC merges into another corporation and less than 70% of the consideration receivable by the holders of the SPAC’s common stock is payable in the shares of a public company (e.g., in an all-cash deal), the exercise price of the warrants will be adjusted based on a warrant value using the Black-Scholes model. However, that Black-Scholes warrant value is calculated differently for private placement and public warrants. That is, one uses an uncapped call option pricing model, while the other uses a capped call option pricing model. As a result, the settlement amount would change when a private placement warrant becomes a public warrant because it is transferred to a non-affiliate of the sponsor.</p>	<p>Because the settlement amount depends solely on who holds the instrument, and this is not an input to the fair value of a fixed-for-fixed option or forward on equity shares, this provision would cause the warrants to fail Step 2 of the indexation guidance. As a result, the private placement warrants would be classified as liabilities.</p>

Example of provision in a SPAC warrant agreement

4.4. ... If less than 70% of the consideration receivable by the holders of the Common Stock in the applicable event is payable in the form of common stock in the successor entity that is listed for trading on a national securities exchange or is quoted in an established over-the-counter market, or is to be so listed for trading or quoted immediately following such event, and if the Registered Holder properly exercises the Warrant within thirty (30) days following the public disclosure of the consummation of such applicable event by the Company pursuant to a Current Report on Form 8-K filed with the Commission, the Warrant Price shall be reduced by an amount (in dollars) equal to the difference of (i) the Warrant Price in effect prior to such reduction minus (ii) (A) the Per Share Consideration (as defined below) (but in no event less than zero) minus (B) the Black-Scholes Warrant Value (as defined below). The "Black-Scholes Warrant Value" means the value of a Warrant immediately prior to the consummation of the applicable event based on the Black-Scholes Warrant Model for a Capped American Call on Bloomberg Financial Markets ("Bloomberg"). For purposes of calculating such amount, (i) Section 6 of this Agreement shall be taken into account,^a (ii) the price of each Ordinary Share shall be the volume weighted average price of the Ordinary Shares during the ten (10) trading day period ending on the trading day prior to the effective date of the applicable event, (iii) the assumed volatility shall be the 90 day volatility obtained from the HVT function on Bloomberg determined as of the trading day immediately prior to the day of the announcement of the applicable event and (iv) the assumed risk-free interest rate shall correspond to the U.S. Treasury rate for a period equal to the remaining term of the Warrant. ...

^a In the example, Section 6 provides that certain redemption provisions do not apply to the private placement warrants.

Cashless exercise with different settlement amounts for public vs. private warrants

Adjustment provision (affects private placement warrants only)	Analysis
<p>The warrants may be exercised on a "cashless basis" in certain circumstances. However, the "fair market value" input used to derive the settlement amount of a warrant upon a cashless exercise is defined as the average last sale price of the common stock over a number of days for private placement warrants, and the volume weighted average price of the common stock over a number of days for public warrants. As a result, the settlement amount changes when a private placement warrant becomes a public warrant because of a transfer to a non-affiliate of the sponsor.</p>	<p>Because the settlement amount depends solely on who holds the instrument, and this is not an input to the fair value of a fixed-for-fixed option or forward on equity shares, this provision would cause the warrants to fail Step 2 of the indexation guidance. As a result, the private placement warrants would be classified as liabilities.</p>

Example of provision in a SPAC warrant agreement

3.3.1 (c) **With respect to any Private Placement Warrant**, so long as such Private Placement Warrant is held by the Sponsor or a Permitted Transferee, by surrendering the Warrants for that number of shares of Common Stock equal to the quotient obtained by dividing (x) the product of the number of shares of Common Stock underlying the Warrants, multiplied by the difference between the Warrant Price and the “Fair Market Value”, as defined in this subsection 3.3.1(c), by (y) the Fair Market Value. Solely for purposes of this subsection 3.3.1(c), **the “Fair Market Value” shall mean the average last sale price of the Common Stock for the ten (10) trading days ending on the third trading day prior to the date on which notice of exercise of the Warrant is sent to the Warrant Agent ...**

7.4.1 Registration of the Common Stock^b: ... holders of the Warrants shall have the right, during the period beginning on the 61st Business Day after the closing of the Business Combination ... to exercise such Warrants on a “cashless basis,” by exchanging the Warrants (in accordance with Section 3(a)(9) of the Securities Act (or any successor rule) or another exemption) for that number of shares of Common Stock equal to the quotient obtained by dividing (x) the product of the number of shares of Common Stock underlying the Warrants, multiplied by the difference between the Warrant Price and the “Fair Market Value” (as defined below) by (y) the Fair Market Value. Solely for purposes of this subsection 7.4.1, **“Fair Market Value” shall mean the volume weighted average price of the Common Stock as reported during the ten (10) trading day period ending on the trading day prior to the date that notice of exercise is received by the Warrant Agent from the holder of such Warrants or its securities broker or intermediary ...** [emphasis added]

^b In the example, section 7.4.1 applies to Public Warrants.

\$0.10 redemption feature

Adjustment provision (affects private placement warrants only)	Analysis
Private placement warrants typically are not subject to the \$0.10 redemption feature discussed above but will be once those warrants are transferred to a non-affiliate of the sponsor and become public warrants. As a result, the settlement amount changes when a private placement warrant becomes a public warrant.	Because the settlement amount depends solely on who holds the instrument, and this is not an input to the fair value of a fixed-for-fixed option or forward on equity shares, this provision would cause the warrants to fail Step 2 of the indexation guidance. As a result, the private placement warrants would be classified as liabilities.

Example of provision in a SPAC warrant agreement

6.2 Redemption of Warrants for Ordinary Shares. Subject to Sections 6.5 hereof, not less than all of the outstanding Warrants may be redeemed, at the option of the Company, beginning ninety (90) days after they are first exercisable and prior to their expiration, at the office of the Warrant Agent, upon notice to the Registered Holders of the Warrants, as described in Section 6.3 below, at a Redemption Price of \$0.10 per Warrant; provided that the last reported sales price of the Ordinary Shares reported has been at least \$10.00 per share (subject to adjustment in compliance with Section 4 hereof), on the trading day prior to the date on which notice of the redemption is given; and provided, further, that there is an effective registration statement covering the Ordinary Shares issuable upon exercise of the Warrants, and a current prospectus relating thereto, available throughout the 30-day Redemption Period (as defined in Section 6.3 below) or the Company has elected to require the exercise of the Warrants on a “cashless basis” pursuant to subsection 3.3.1(b). During the 30-day Redemption Period in connection with a redemption pursuant to this Section 6.2, Registered Holders of the Warrants may elect to exercise their Warrants on a “cashless basis” pursuant to subsection 3.3.1(d) and receive a number of Ordinary Shares determined by reference to the table below, based on the Redemption Date (calculated for purposes of the table as the period to expiration of the Warrants) and the “Fair Market Value” (as such term is defined in subsection 3.3.1(b)) (a “Make-Whole Exercise”).

Fair Market Value of Class A Common Stock

Redemption Date (period to expiration of warrants)	≤\$10.00	\$11.00	\$12.00	\$13.00	\$14.00	\$15.00	\$16.00	\$17.00	≥\$18.00
57 months	0.257	0.277	0.294	0.310	0.324	0.337	0.348	0.358	0.365
54 months	0.252	0.272	0.291	0.307	0.322	0.335	0.347	0.357	0.365
51 months	0.246	0.268	0.287	0.304	0.320	0.333	0.346	0.357	0.365
48 months	0.241	0.263	0.283	0.301	0.317	0.332	0.344	0.356	0.365
45 months	0.235	0.258	0.279	0.298	0.315	0.330	0.343	0.356	0.365
42 months	0.228	0.252	0.274	0.294	0.312	0.328	0.342	0.355	0.364
39 months	0.221	0.246	0.269	0.290	0.309	0.325	0.340	0.354	0.364
36 months	0.213	0.239	0.263	0.285	0.305	0.323	0.339	0.353	0.364
33 months	0.205	0.232	0.257	0.280	0.301	0.320	0.337	0.352	0.364
30 months	0.196	0.224	0.250	0.274	0.297	0.316	0.335	0.351	0.364
27 months	0.185	0.214	0.242	0.268	0.291	0.313	0.332	0.350	0.364
24 months	0.173	0.204	0.233	0.260	0.285	0.308	0.329	0.348	0.364
21 months	0.161	0.193	0.223	0.252	0.279	0.304	0.326	0.347	0.364
18 months	0.146	0.179	0.211	0.242	0.271	0.298	0.322	0.345	0.363
15 months	0.130	0.164	0.197	0.230	0.262	0.291	0.317	0.342	0.363
12 months	0.111	0.146	0.181	0.216	0.250	0.282	0.312	0.339	0.363
9 months	0.090	0.125	0.162	0.199	0.237	0.272	0.305	0.336	0.362
6 months	0.065	0.099	0.137	0.178	0.219	0.259	0.296	0.331	0.362
3 months	0.034	0.065	0.104	0.150	0.197	0.243	0.286	0.326	0.361
0 months	–	–	0.042	0.115	0.179	0.233	0.281	0.323	0.361

Example of provision in a SPAC warrant agreement (continued)

6.5 Exclusion of Private Placement Warrants. The Company agrees that the redemption rights provided in this Section 6 hereof shall not apply to the Private Placement Warrants if at the time of the redemption such Private Placement Warrants continue to be held by the Sponsor or its Permitted Transferees. However, once such Private Placement Warrants are transferred (other than to Permitted Transferees in accordance with Section 2.6 hereof), the Company may redeem the Private Placement Warrants pursuant to this Section 6, **provided** that the criteria for redemption are met, including the opportunity of the holder of such Private Placement Warrants to exercise the Private Placement Warrants prior to redemption pursuant to Section 6.4. Private Placement Warrants that are transferred to persons other than Permitted Transferees shall upon such transfer cease to be Private Placement Warrants and shall become Public Warrants under this Agreement.

Different settlement amount for officers and directors

Adjustment provision (affects public warrants only)	Analysis
<p>Some warrant agreements allow the SPAC to call the public warrants for \$0.10 per warrant when the share price of Class A common stock equals or exceeds \$10. During the redemption period, a holder can exercise public warrants on a cashless basis and receive a number of shares based on a "make whole" table in the warrant agreement, which does not represent the fair value of the warrant at time of settlement. However, holders who are officers or directors of the SPAC will receive a settlement amount based on the closing price of the public warrant on a specified date.</p>	<p>Because the settlement amount depends solely on who holds the instrument, and this is not an input to the fair value of a fixed-for-fixed option or forward on equity shares, this provision would cause the warrants to fail Step 2 of the indexation guidance. As a result, the public warrants would be classified as liabilities.</p>

Example of provision in a SPAC warrant agreement

Public Warrants Held by the Company's Officers or Directors: The Company agrees that if Public Warrants are held by any of the Company's officers or directors, the Public Warrants held by such officers and directors will be subject to the redemption rights provided in Section 6.2, except that such officers and directors shall only receive "Fair Market Value" ("Fair Market Value" in this Section 6.6 shall mean the closing price of the Public Warrants on the Alternative Redemption Date) for such Public Warrants so redeemed.

Capped settlement amount when there is no effective registration statement	
Adjustment provision (affects public and private placement warrants)	Analysis
<p>Warrants issued by a SPAC only physically settle when there is an effective registration statement – that is, holders pay \$11.50 per warrant in cash in exchange for one share of Class A common stock. When there is no effective registration statement, a provision in the warrant agreement may cap the number of Class A shares issuable under the warrant (e.g., at .361 shares per warrant) in a cashless exercise, which is the only option in this situation.</p> <p>To illustrate that difference, if there is an effective registration statement, the warrants will be physically settled upon exercise, and the holder will receive one share that trades at \$20 in exchange for its \$11.50 payment, representing a settlement amount of \$8.50. However, under the cap that applies when there is no effective registration statement, the holder would only be entitled to receive .361 shares (i.e., a \$7.20 settlement amount) in a cashless exercise.</p>	<p>The number of Class A shares issuable upon warrant exercises depends on whether there is an effective registration statement. Because an effective registration statement is not an input to the fair value option model for a fixed-for-fixed option or forward, this provision precludes the warrants from being considered indexed to the SPAC's own stock, and the private placement warrants and public warrants would be classified as liabilities.</p>
Example of provision in a SPAC warrant agreement	
<p>7.4.1 Registration of the Common Stock. The Company agrees that as soon as practicable, but in no event later than twenty (20) Business Days after the closing of its initial Business Combination, it shall use its commercially reasonable efforts to file with the Commission a registration statement for the registration, under the Securities Act, of the issuance of the shares of Common Stock issuable upon exercise of the Warrants. The Company shall use its commercially reasonable efforts to cause the same to become effective within sixty (60) days after the closing of the Business Combination and to maintain the effectiveness of such registration statement, and a current prospectus relating thereto, until the expiration of the Warrants in accordance with the provisions of this Agreement. If any such registration statement has not been declared effective by the 60th Business Day following the closing of the Business Combination, holders of the Warrants shall have the right, during the period beginning on the 61st Business Day after the closing of the Business Combination and ending upon such registration statement being declared effective by the Commission, and during any other period when the Company shall fail to have maintained an effective registration statement covering the shares of Common Stock issuable upon exercise of the Warrants, to exercise such Warrants on a "cashless basis," by exchanging the Warrants (in accordance with Section 3(a)(9) of the Securities Act (or any successor rule)</p>	

Example of provision in a SPAC warrant agreement (continued)

or another exemption) for that number of shares of Common Stock equal to the lesser of (A) the quotient obtained by dividing (x) the product of the number of shares of Common Stock underlying the Warrants, multiplied by the excess of the "Fair Market Value" (as defined below) over the Warrant Price by (y) the Fair Market Value and (B) 0.365. Solely for purposes of this subsection 7.4.1, "Fair Market Value" shall mean the volume weighted average price of the Common Stock as reported during the ten (10) trading day period ending on the trading day prior to the date that notice of exercise is received by the Warrant Agent from the holder of such Warrants or its securities broker or intermediary. The date that notice of cashless exercise is received by the Warrant Agent shall be conclusively determined by the Warrant Agent. In connection with the "cashless exercise" of a Public Warrant, the Company shall, upon request, provide the Warrant Agent with an opinion of counsel for the Company (which shall be an outside law firm with securities law experience) stating that (i) the exercise of the Warrants on a cashless basis in accordance with this subsection 7.4.1 is not required to be registered under the Securities Act and (ii) the shares of Common Stock issued upon such exercise shall be freely tradable under United States federal securities laws by anyone who is not an affiliate (as such term is defined in Rule 144 under the Securities Act (or any successor rule)) of the Company and, accordingly, shall not be required to bear a restrictive legend. Except as provided in subsection 7.4.2, for the avoidance of any doubt, unless and until all of the Warrants have been exercised, the Company shall continue to be obligated to comply with its registration obligations under the first three sentences of this subsection 7.4.1 [emphasis added].

Cap provisions in certain SPAC warrant agreements might preclude the warrants from being classified as equity.

How we see it

Cap provisions often preclude SPAC warrants from being considered indexed to the SPAC's own stock. A SPAC or a combined company should carefully review the warrant agreement to identify any caps on settlement amounts. Once those caps are identified, the SPAC needs to determine whether any of those caps could change the settlement amount for any reason that would not be an input to the pricing model for a fixed-for-fixed forward or option. If that is the case, the warrants would fail Step 2 of the indexation guidance and would be precluded from being classified in equity.

Freestanding equity-linked instruments, such as SPAC warrants that are not indexed to an entity's own stock under ASC 815-40-15, are required to be classified as assets or liabilities and measured at fair value, with subsequent changes in fair value recognized in earnings.¹⁰

The equity classification guidance (ASC 815-40-25)

An instrument that is indexed to the entity's own equity should also be evaluated to determine whether the form of contractual settlement supports a conclusion of equity classification. If an issuer is able, in all circumstances, to settle the contract in net shares or by physical settlement (i.e., the gross exchange of the contractual shares for the contractual consideration), the contract qualifies for equity classification.

The equity classification guidance includes conditions that focus on whether the issuer will have the ability, in all cases, to settle in shares. If these conditions are not met, net cash settlement is presumed, and equity classification is not permitted.

The contract is precluded from being classified in equity if it must be net cash settled, or such a settlement is (1) a contractual alternative that is not within the control of the issuer or (2) presumed under the guidance. In determining whether an entity controls settlement in shares, the contractual provisions and the entity's current capital structure and any legal barriers to share settlement should be considered.

The equity classification guidance provides limited exceptions for net cash settlement. ASC 815-40-25-8 says equity classification isn't precluded if net cash settlement is triggered by an event that is not within the entity's control and the counterparty is permitted to receive or deliver, upon settlement, the same form of consideration (e.g., cash, debt, other assets) as holders of the shares underlying the contract. ASC 815-40-55-3 illustrates the application of this exception using a change-in-control provision as the triggering event.



SEC staff statement – equity classification considerations

The SEC staff statement said the exception in ASC 815-40-25-8 that allows equity classification applies to events that “fundamentally change the ownership or capitalization of an entity, such as a change in control of the entity, or a nationalization of the entity.”

The terms of both public warrants and private placement warrants often include a provision that provides for net cash settlement in the event of a tender or exchange offer that is made and accepted by the holders of more than 50% of the outstanding shares underlying the warrants. The SEC staff said that, in the fact pattern it evaluated involving such a provision, the exception didn't apply and the warrants should be classified as liabilities.

How we see it

We understand that the issuer in the fact pattern reviewed by the staff had two classes of voting shares outstanding. Consequently, a tender or exchange offer accepted by 50% of the holders of the class of shares underlying the warrant would not result in the exchange of a number of shares that could result in a change in control. As a result, the SPAC could not apply the exception in ASC 815-40-25-8.

Illustration 1 – Tender offer provision when a SPAC has two classes of common stock

Before merging with a target operating company, SPAC X has two classes of common stock outstanding: Class A and Class B. Both classes provide holders with the same voting rights (one vote per share) and dividend rights. When the warrants were issued, there were 80 shares of Class A and 20 shares of Class B outstanding. When the warrants are exercised, SPAC X will settle by issuing Class A shares.

The warrant agreement has a tender offer provision that allows the warrant holders to receive the same form of consideration received by the Class A shareholders, if the entity that makes the tender offer will own more than 50% of the Class A shares upon the completion of the offer. If the tender offer results in the acquisition of 51% of the Class A shares, the entity that made the offer will hold approximately 41% of SPAC X, which would not be a controlling interest.

Because a tender offer for the Class A shares at the 50% level would not result in the maker of the tender offer owning a controlling interest in SPAC X, it is not an event that fundamentally changes the ownership or capitalization of an entity, as provided in the SEC staff statement. Therefore, SPAC X cannot apply the exception in ASC 815-40-25-8 and must classify the warrants as liabilities.

Example of a tender offer provision in a SPAC warrant agreement

... (iii) if a tender, exchange or redemption offer shall have been made to and accepted by the holders of the Common Stock (other than a tender, exchange or redemption offer made by the Company in connection with redemption rights held by stockholders of the Company as provided for in the Company's amended and restated certificate of incorporation or as a result of the repurchase of shares of Common Stock by the Company if a proposed initial Business Combination is presented to the stockholders of the Company for approval) under circumstances in which, upon completion of such tender or exchange offer, the maker thereof, together with members of any group (within the meaning of Rule 13d-5(b)(1) under the Exchange Act (or any successor rule)) of which such maker is a part, and together with any affiliate or associate of such maker (within the meaning of Rule 12b-2 under the Exchange Act (or any successor rule)) and any members of any such group of which any such affiliate or associate is a part, own beneficially (within the meaning of Rule 13d-3 under the Exchange Act (or any successor rule)) more than 50% of the outstanding shares of Common Stock, the holder of a Warrant shall be entitled to receive as the Alternative Issuance, the highest amount of cash, securities or other property to which such holder would actually have been entitled as a stockholder if such Warrant holder had exercised the Warrant prior to the expiration of such tender or exchange offer, accepted such offer and all of the Common Stock held by such holder had been purchased pursuant to such tender or exchange offer, subject to adjustments (from and after the consummation of such tender or exchange offer) as nearly equivalent as possible to the adjustments provided for in this Section 4 ...

Freestanding equity-classified instruments are initially measured at fair value (or allocated value). Subsequent changes in fair value are not recognized as long as the contract continues to be classified in equity. In contrast, if a freestanding instrument that was indexed to the issuer's own stock fails the requirements for equity classification, it should be classified as an asset or liability and initially measured at fair value. The equity classification guidance specifies that subsequent changes in fair value are recorded in earnings.

Derivative disclosure considerations (ASC 815)

If an equity-linked instrument is in the scope of ASC 480 or ASC 815-40 and is classified as a liability (or an asset), the instrument should be further evaluated to determine whether it would also be a derivative pursuant to ASC 815. If so, that instrument would be subject to any disclosure requirements for derivative instruments. To be a derivative pursuant to ASC 815, an equity contract should have all of the following characteristics:

Characteristics of a derivative			
One or more underlyings	One or more notional amounts or payment provisions or both	An initial net investment that is smaller than would be required to acquire the underlying asset	Net settlement

Refer to section 2.4 of our FRD publications, *Derivatives and hedging (after the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities)* or *Derivatives and hedging (before the adoption of ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities)*, as applicable, for additional information on the definition of a derivative.

EPS considerations (ASC 260)

ASC 260 generally requires the use of the treasury stock method for the dilutive effect of a warrant. Warrants issued by a SPAC are typically contingently exercisable (i.e., after an IPO or upon a successful business combination). For EPS purposes, the warrants would generally not be reflected in basic or diluted EPS for the SPAC until the contingency is resolved.

If the warrants give the holders nonforfeitable rights to dividends paid on the underlying stock prior to exercise, they represent participating securities, regardless of whether the SPAC actually declares or pays dividends, and the use of the two-class method for calculating EPS would be required.

For further discussion of the treasury stock method, contingently issuable shares and participating securities, see sections 4.3, 4.8 and 5.2, respectively, of our FRD publication, [*Earnings per share*](#).

Underwriter's overallotment option

Many SPAC IPOs contain features that provide the underwriter with the option to obtain more of the units sold in the IPO. These provisions permit the underwriter to fill orders slightly in excess of the planned amount of an offering to promote market efficiencies. The option typically expires after 30 or 45 days.

In determining the appropriate accounting for the underwriter's overallotment option, a SPAC considers the following questions:

- ▶ *Is the overallotment option a freestanding financial instrument?* This option is generally considered to be freestanding from the units the SPAC issues. That is because the underwriter holds the option, and the public investors receive the units. However, if the underwriter purchases units at the same time it obtains the overallotment option from the SPAC, the concurrently issued instruments (i.e., the overallotment option and the Class A common stock and public warrant issued as a unit) should be analyzed to determine whether they are freestanding from each other or whether one is embedded in the other. That determination is based on the definition of a freestanding financial instrument in ASC 480. For further discussion of the unit of account for overallotment options, see section 5.12 of our FRD publication, [*Issuer's accounting for debt and equity financings \(after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity\)*](#).
- ▶ *If the overallotment option is freestanding, how should it be classified and measured?* If the option is freestanding, it is generally a liability under ASC 480 because one of its underlyings – the Class A shares the underwriter will receive upon exercise of the overallotment option – is redeemable upon the SPAC merger and thus would require the transfer of assets by the SPAC (ASC 480-10-25-8). Under that guidance, the option should be initially and subsequently measured at fair value with changes in fair value recognized in earnings.

While an overallotment option that is short-term and has an at-the-money strike price of \$10 per unit at the issuance date may have minimal value, the volatility of the underlying Class A shares may create value, and the value of the option could change over its life.

Issuance costs

For stock that is classified in equity, direct and incremental costs paid to third parties that are related to its issuance, such as legal fees, printing costs, and bankers' or underwriters' fees, should be accounted for as a reduction of the proceeds of the stock. Internal costs that meet the incremental and direct criteria (e.g., travel costs directly related to financing) may also be accounted for as a reduction of proceeds, but costs such as salaries, rent and other period costs

are not capitalizable as issuance costs. For stock classified in equity, stock issuance costs are not amortized or accreted unless the stock is classified in temporary equity and the carrying amount is being accreted to the full redemption amount pursuant to ASC 480-10-S99-3A.

Issuance costs for stock requiring liability classification pursuant to ASC 480 should be accounted for under the guidance for debt issuance costs, which generally requires the costs to be amortized and recognized as additional interest expense over the life of the instrument using the effective interest method pursuant to ASC 835-30-35-2 through 35-3.

Issuance costs related to liability-classified instruments (e.g., liability-classified warrants) that are subject to an ongoing fair value measurement should be immediately expensed.

Costs related to the issuance of instruments in a basket transaction (e.g., IPO units) that are freestanding and accounted for separately should generally be allocated between the instruments. A systematic and rational approach based on the facts and circumstances should be applied. For a SPAC's IPO units, allocation of issuance costs between the Class A shares and public warrants may result in a discount on the Class A shares (i.e., a reduction in the carrying amount of the shares). Because Class A shares are redeemable by holders upon a merger with a private operating company (i.e., the de-SPAC transaction), accretion of this discount may be required pursuant to ASC 480-10-S99-3A.

The table below summarizes the treatment of direct and incremental issuance costs depending on the type of instrument and its classification:

Type of issuance	Classification of instrument	Accounting for direct and incremental costs
Class B shares	Permanent equity	<ul style="list-style-type: none"> ▶ Considered a reduction of equity proceeds and recognized in additional paid-in capital (APIC) ▶ Not subject to amortization
Private placement warrants	Permanent equity	▶ Considered a reduction of equity proceeds and recognized in APIC
	Liability	▶ Expensed as incurred
Class A shares	Temporary equity	<ul style="list-style-type: none"> ▶ Considered a reduction of equity proceeds and recognized in APIC ▶ Subject to amortization before the de-SPAC transaction
Public warrants	Permanent equity	▶ Considered a reduction of equity proceeds and recognized in APIC
	Liability	▶ Expensed as incurred

Deferred underwriter fees

The underwriter of the SPAC IPO often agrees to defer all or a part of its compensation until the closing of the de-SPAC transaction. Typically, the underwriting fee is approximately 5.5% of the IPO gross proceeds, with 2% paid upon the SPAC IPO and 3.5% paid after the de-SPAC transaction.

The 2% paid upon the SPAC IPO is an issuance cost for the IPO units. Refer to the [Issuance costs](#) section above for further discussion.

We generally believe that the deferred underwriter fees should be recognized upon the IPO if the criteria in ASC 450¹¹ are met (i.e., the de-SPAC transaction is probable of occurring, and the underwriter fee can be reasonably estimated). An assertion of “probable” for this purpose should be consistent with how the SPAC considers the likelihood of the de-SPAC transaction occurring for other purposes, such as in the valuation of warrants and the subsequent measurement assessment of Class A shares under the temporary equity guidance.

SPAC merger (de-SPAC transaction)



When a SPAC identifies a target and prepares to merge with it, there are several accounting issues the SPAC will need to address. For example, while the SPAC is the legal acquirer of the private target company, the accounting for the transaction depends on which entity is considered the acquirer for accounting purposes (i.e., the accounting acquirer).

If a SPAC is determined to be the accounting acquirer, the transaction is accounted for as a business combination in accordance with the guidance in ASC 805 (i.e., as a forward merger). If the private target is determined to be the accounting acquirer, the transaction is accounted for as a reverse recapitalization rather than as a business combination. That is, the accounting will be similar to that of a capital infusion because the only pre-combination asset of the SPAC is likely to be cash obtained from public investors. For additional information on determining the accounting acquirer in a SPAC merger, refer to our Technical Line, [***Navigating the requirements for merging with a special purpose acquisition company.***](#)

The following discussion focuses on accounting considerations for financial instruments issued in a de-SPAC transaction.

PIPEs

When a SPAC conducts its IPO, it raises the amount of capital it expects to need to acquire a target in a de-SPAC transaction. However, if the SPAC determines that additional capital may be required to complete the de-SPAC transaction, a private investment in public equity (PIPE) can be used to provide it.

PIPEs are generally executed in the form of contingent forward purchase commitments by affiliates of the sponsor of the SPAC or institutional investors to purchase common stock of the SPAC at a fixed price (e.g., \$10) per share. PIPEs are generally settled contemporaneously with a de-SPAC transaction.

Given that a PIPE is a contract to issue an equity instrument of the SPAC, the SPAC should consider the analysis discussed above in the [***SPAC warrants, including public warrants***](#) section, with appropriate consideration of ASC 480 and ASC 815-40, to determine the classification of a PIPE. The terms of PIPE arrangements can vary significantly. Therefore, these terms and the facts and circumstances of the SPAC should be carefully evaluated to determine the accounting.

Class A shares

Class A shares issued in connection with a SPAC merger (e.g., Class A shares issued in connection with a PIPE transaction) generally aren’t redeemable. Once issued, they are classified in permanent equity, assuming that no other redemption features exist.

In addition, once the SPAC successfully completes a merger with a target, the holders of the Class A shares issued in the IPO no longer have the right to redeem those shares. At that time, the carrying amount of the Class A shares previously classified in temporary equity should be reclassified into the permanent equity of the combined company pursuant to ASC 480-10-S99-3A, assuming no other redemption features exist. Amounts recorded in accordance with ASC 480-10-S99-3A while the shares were classified in temporary equity should not be reversed upon the reclassification from temporary equity to permanent equity.

Warrants

The determination of whether warrants issued by the SPAC before the merger should be classified in equity or as liabilities upon the de-SPAC transaction is based on the analysis as described in the ***SPAC warrants, including public warrants*** section above. In certain circumstances, warrants may need to be reclassified upon the de-SPAC transaction.

Reassessment under ASC 480

The guidance in ASC 480-10-25-8 requires a financial instrument (other than an outstanding share) to be classified as a liability (or an asset in some circumstances) based on whether, at inception, it embodies an obligation to repurchase the issuer's shares by transferring assets.

Prior to the de-SPAC transaction, the Class A shares underlying SPAC warrants are redeemable by the holder for cash upon the SPAC merger transaction. If these warrants are exercisable before the de-SPAC transaction, they are required to be classified as liabilities pursuant to ASC 480-10-25-8. However, upon the merger transaction, Class A shares will no longer be redeemable by holders. The combined entity should apply judgment to determine whether it is appropriate to reassess the classification of these warrants because the Class A shares underlying them are no longer redeemable for cash. While ASC 480 does not require or explicitly permit a reassessment of the classification of an instrument once it is initially recognized as a liability pursuant to ASC 480-10-25-8 through 25-13, we generally believe that the combined entity may make an accounting policy election to reassess the classification of these warrants if they no longer obligate the combined entity to transfer assets. The combined entity may determine upon reassessment that these warrants can be reclassified from a liability to equity.

Reassessment under ASC 815-40

ASC 815-40-35-8 requires an issuer to reassess the classification of equity-linked instruments at each balance sheet date, and classification conclusions could change due to changes in the issuer's capital structure or other transactions or events that occur during a reporting period. If the classification changes because of events occurring during the reporting period, the instrument is reclassified as of the date of the event that caused the reclassification.

SPAC mergers trigger a reassessment if they change the capital structure of the combined entity. In many cases, that happens because Class B shares generally convert automatically into Class A shares upon the merger, which could result in there being only one remaining class of voting securities.

If there is only one class of voting securities remaining, the change-of-control exception in ASC 815-40-55-3 may apply, which would mean SPAC warrants that were classified as liabilities because they previously did not meet the exception could now be reclassified as equity. If reclassification is required, SPAC warrants should be reclassified at their fair value on the merger date.

Earn-out arrangements

When sponsors and the selling shareholders of the target company cannot agree on the value of the target, they often bridge the gap by negotiating an earn-out arrangement. Earn-out arrangements may also be used to make SPACs more attractive to the Class A shareholders of the SPAC and shareholders of potential target companies. These earn-out arrangements can be executed by:

- ▶ Subjecting a portion of the outstanding Class B shares to an “earnout” provision, with these shares vesting only if certain post-closing trading price targets are achieved
- ▶ Issuing additional shares of the combined company to the selling shareholders when certain stock price levels of the combined company are achieved

Frequently, the vesting conditions also include the occurrence of certain liquidity events (e.g., a merger of the combined entity with another entity, sale of substantially all of the assets of the combined entity). Earnout arrangements are typically effective for five to seven years after the merger.

This section focuses on the accounting for earn-out provisions when the SPAC merger is accounted for as a reverse recapitalization (i.e., the operating company is determined to be the accounting acquirer).

Refer to the *Earn-out provisions in a business combination* section in our Technical Line, [**Navigating the requirements for merging with a special purpose acquisition company**](#), for a discussion of how an earn-out should be considered in a business combination (i.e., when the SPAC is identified as the accounting acquirer and the target company is a business).

Earn-out arrangements may need to be classified as liabilities under ASC 815-40.

Classification

Earn-out arrangements are typically considered freestanding financial instruments because they are issued upon the merger transaction, separately and apart from other instruments. Furthermore, an earn-out arrangement often includes multiple settlements based on different triggering events. While the holders will receive shares when each triggering event occurs, the components are not legally transferable by the holders. In these circumstances, the earn-out arrangement is considered a freestanding financial instrument that contains multiple settlement provisions triggered by different events.

Earn-out arrangements may be issued to the employees of the target as part of the merger negotiation. For those arrangements, ASC 718 should be considered. See further discussion in the [**Earn-out arrangements – stock-based compensation**](#) section below. For earn-out arrangements that aren't share-based payments under ASC 718, the analysis is the same as the accounting evaluation for the classification of SPAC warrants that are not accounted for under ASC 718, which is described in the [**SPAC warrants, including public warrants**](#) section above.

Distinguishing liabilities from equity (ASC 480)

Earn-out arrangements generally are not classified as liabilities under ASC 480 because they do not represent obligations that must or may be settled by transferring assets and are not obligations to issue a variable number of shares that meet one of the conditions described in ASC 480-10-25-14.

If an earn-out arrangement is not an ASC 480 liability, it should be evaluated under the indexation guidance (ASC 815-40-15) and the equity classification guidance (ASC 815-40-25) to determine whether it should be classified as a liability or equity.

The indexation guidance (ASC 815-40-15)

Earn-out arrangements typically have share-price triggers. For example, an earn-out arrangement may require the combined entity to issue an additional 1,000,000 shares to selling shareholders if the volume-weighted average price (VWAP) of the combined entity exceeds \$15 per share during a certain timeframe and an additional 1,000,000 shares if VWAP exceeds \$20 per share during the same timeframe.

Earn-out arrangements also typically contain provisions that accelerate settlement upon liquidity events (e.g., a change in control of the combined entity). These provisions could change the number of shares to be issued (i.e., the settlement amount) under the arrangement.

Entities evaluating their earn-out arrangements should pay particular attention to features that change the settlement amount, because some adjustment features can preclude the earn-out arrangement from being considered indexed to an issuer's stock under the indexation guidance and, therefore, require the arrangement to be classified as a liability. Generally, when the settlement amount of an earn-out arrangement changes based on stock price, the arrangement may be considered indexed to an entity's own stock. But provisions that change the settlement amount for other reasons (e.g., a change in control provision that entitles the holder to all remaining unearned shares under the arrangement, regardless of stock price) may preclude the arrangement from being indexed to the entity's own stock.

The following examples illustrate common terms in earn-out arrangements, the application of the indexation guidance to those terms and the resulting classification of the arrangements:

Illustration 2 – Earn-out arrangement – vesting based on share-price triggers

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the combined entity may issue up to 4,000,000 additional Class A shares to the OpCo X selling shareholders if certain share-price thresholds of the combined company are met within five years from the consummation date of the merger. The triggering events are as follows:

- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$12, 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$15, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$18, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$20, another 1,000,000 shares are issued.

If none of the share-price targets is met within five years of the merger date, the selling shareholders will not be entitled to any additional shares. Therefore, the triggering events are considered exercise contingencies because their occurrences trigger the holder's ability to settle the earn-outs and receive shares.

An exercise contingency based on the Class A share price is permissible under Step 1 of the indexation guidance. In Step 2 of the analysis, the settlement amount changes solely based on the share price of the Class A stock. Because share price is an input to the fair value of a fixed-for-fixed forward or option on equity shares, this arrangement is considered indexed to an entity's own stock. If the criteria for equity classification under ASC 815-40-25 are also met (see discussion below), this earn-out arrangement would be classified in equity.

Illustration 3 - Earn-out arrangement – a change in control triggers full vesting

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the combined entity may issue up to 4,000,000 additional Class A shares to the OpCo X selling shareholders if certain share-price thresholds of the combined company are met within five years from the consummation date of the merger. The triggering events are as follows:

- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$12, 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$15, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$18, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$20, another 1,000,000 shares are issued.
- ▶ If there is a change in control during the five-year period, all 4,000,000 shares will immediately be issued to the selling shareholders.

If none of the share-price targets above is met within five years from the merger date, the selling shareholders will not be entitled to any additional shares, unless there is a change-in-control transaction. If the combined entity undergoes a change-in-control transaction, which includes (1) a sale of all or substantially all of the combined entity's assets or (2) any merger of the combined entity with another company, all of the additional shares will be issued, regardless of whether any share-price triggers were met.

All of these triggering events are considered exercise contingencies because their occurrences trigger the holder's ability to settle the earn-outs and receive shares. Because the exercise contingencies are based on either the share price of the combined entity or a change in control of the combined entity, they are permissible under Step 1.

In Step 2 of the analysis, the settlement amount under this arrangement changes not only based on the share price of the Class A shares but also based on whether there is a change in control of the combined entity over the next five years. Because a change-in-control event is not an input to the fair value of a fixed-for-fixed forward or option on equity shares, this arrangement would not be considered indexed to an entity's own stock under Step 2. Therefore, the earn-out arrangement must be classified as a liability.

Illustration 4 – Earn-out arrangement – a change in control with a minimum price trigger

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the combined entity may issue up to 4,000,000 additional Class A shares to the OpCo X selling shareholders if certain share-price thresholds of the combined company are met within five years from the consummation date of the merger. The triggering events are as follows:

- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$12, 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$15, another 1,000,000 shares are issued.

- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$18, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$20, another 1,000,000 shares are issued.
- ▶ If there is a change in control during the five-year period, and the per-share transaction price meets or exceeds \$12, the entire 4,000,000 shares will immediately be issued to the selling shareholders.

If none of the share-price targets above is met within five years from the merger date, the selling shareholders will not be entitled to any additional shares, unless there is a change-in-control transaction at a price that meets or exceeds \$12 per share. If the combined entity undergoes a change-in-control transaction, which includes (1) a sale of all or substantially all of the combined entity's assets or (2) any merger of the combined entity with another company, and the per-share price received by the shareholders of the combined entity in the change-in-control transaction meets or exceeds \$12, all of the shares will be issued, regardless of whether any share-price triggers above \$12 were met.

Similar to the conclusion reached for Illustration 3 above, this arrangement would not be precluded from equity classification under Step 1 of the indexation guidance.

In Step 2 of the analysis, the settlement amount under this arrangement changes not only based on the share price of the Class A shares but also based on whether there is a change in control of the combined entity over the next five years. Because a change in control is not an input to the fair value of a fixed-for-fixed forward or option on equity shares, this arrangement would not be considered indexed to an entity's own stock under Step 2. Therefore, the earn-out arrangement must be classified as a liability.

Illustration 5 – Earn-out arrangement – vesting based on change-in-control price triggers

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the combined entity may issue up to 4,000,000 additional Class A shares to the OpCo X selling shareholders if certain share-price thresholds of the combined company are met within five years from the consummation date of the merger. The triggering events are as follows:

- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$12, 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$15, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$18, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$20, another 1,000,000 shares are issued.
- ▶ If there is a change in control during the five-year period, the per-share price in the change-in-control transaction will be used to determine whether the price targets have been met and, if so, the number of shares that will be issued.

If none of the share-price targets above is met within five years from the merger date, the selling shareholders will not be entitled to any additional shares, unless there is a change-in-control transaction at a per-share price that meets or exceeds those targets. That is, if the combined entity undergoes a change-in-control transaction, which includes (1) a sale of all or substantially all of the combined entity's assets or (2) any merger of the combined entity with another company, the number of shares to be issued (if any) will be based on the per-share price determined to be received by the shareholders of the combined entity in the transaction.

For example, if the per-share price in the change-in-control transaction is \$19 per share, the combined entity will issue 3,000,000 shares to the selling shareholders. If 1,000,000 shares were issued before the change-of-control transaction because the \$12 VWAP trigger had been met, an additional 2,000,000 shares would be issued upon the change-in-control transaction for exceeding both the \$15 and \$18 targets.

Similar to the conclusion reached for Illustration 3 above, this arrangement would not be precluded from equity classification under Step 1 of the indexation guidance.

In Step 2 of the analysis, it is important to determine whether the settlement amount varies solely based on the Class A share price. In this example, the number of shares to be issued is determined based on the VWAP and the per-share price.

It is also important to determine whether the per-share price in a change-in-control transaction represents the fair value or an approximation of the fair value of a Class A share. For example, if the calculation of the per-share price in a change-in-control transaction includes the shares that would be issued under the earn-out arrangement, that price may represent the fair value of a Class A share. If, however, the per-share price calculation excludes the shares that would be issued under the earn-out arrangement, that price may not represent the fair value of a Class A share. In that case, the arrangement would not be considered indexed to an entity's own stock, and the earn-out arrangement would be classified as a liability.

A warrant agreement may specify whether the per-share price calculation in a change-of-control transaction should include the shares issuable under an earn-out arrangement, but it is often unclear how that price should be determined. When that is the case, combined entities should seek the advice of legal counsel in determining the most appropriate interpretation.

The equity classification guidance (ASC 815-40-25)

An instrument that is indexed to the entity's own equity should also be evaluated to determine whether the form of contractual settlement supports a conclusion of equity classification. As previously discussed, the basic principle underlying the equity classification guidance is that instruments that require net cash settlement (or force the issuer to net-cash settle or are presumed to net-cash settle under the equity classification guidance) are assets or liabilities, and those that require settlement in shares (or allow the issuer to choose a form of settlement that involves either party transferring shares) are equity instruments. In addition, ASC 815-40-25 provides a list of conditions that must be met for equity classification. Those conditions focus on whether the issuer will have the ability, in all cases, to settle in shares. Otherwise, net-cash settlement is presumed, and equity classification is not permitted.

Earn-out arrangements are designed to be settled through the issuance of additional shares (or by removing restrictions or forfeiture conditions, as discussed below). If the issuer has the ability to issue those shares (i.e., the conditions in ASC 815-40-25 are satisfied), the earn-out arrangement should be classified in equity.

Earn-out arrangements in the form of legally outstanding shares

Some earn-out arrangements with SPAC sponsors are structured in the form of legally outstanding shares. Those shares typically are issued before the merger transaction but are modified as part of the merger to become forfeitable or subject to certain transfer restrictions. Those forfeiture requirements and transfer restrictions typically are removed upon the attainment of certain share-price levels or the occurrence of a specified event (e.g., a change in control).

The accounting guidance for legally outstanding shares differs from the accounting for contracts to issue an entity's own equity. Nevertheless, combined entities should consider the substance of these types of shares. If the legally issued shares do not have substance as shares (e.g., they have no dividend rights or voting rights, they are forfeitable after a period of time unless a certain share-price level is achieved or a specified event occurs), we generally believe the combined entity should evaluate the arrangement under the guidance for contracts in an entity's own equity (ASC 480 and ASC 815-40). That is, because the shares lack substance and are more akin to the earn-out arrangements described above, the same analysis should be followed.

How we see it

The combined entity will need to evaluate the terms of any earn-out arrangements to determine whether equity or liability classification is appropriate. This is particularly important, given that liability classification will require the arrangements to be measured at fair value at each reporting date, with changes in fair value recorded in earnings.

Earn-out arrangements – offsetting entry

Regardless of the classification of an earn-out arrangement, ASC 815-40 requires an entity to initially recognize any instrument within its scope at fair value. There is diversity in views on the offsetting entry for an earn-out arrangement granted to the selling shareholders in a de-SPAC transaction that is accounted for as a reverse recapitalization, assuming it is not otherwise determined to be a share-based payment.

Some believe that the earn-out arrangement represents a distribution to shareholders, akin to a cash dividend, that should be recorded as a reduction in retained earnings. Others believe that because an earn-out arrangement is part of a reverse recapitalization and is negotiated between the sponsor and selling shareholders, it is better represented as an equity restructuring that should be accounted for as a reduction in additional paid-in capital. We generally believe that either approach is acceptable.

Earn-out arrangements – stock-based compensation

When an earn-out arrangement is made with an ASC 718 grantee (e.g., an employee who holds vested and/or unvested options) that could result in the grantee receiving additional share-based payments if the merged company achieves a specified VWAP, the combined entity should determine whether the earn-out arrangement is compensatory and in the scope of ASC 718. If the earn-out is subject to ASC 718, the award contains a market condition that is considered in the grant date fair value because the number of earn-out shares to be issued is contingent upon the merged entity achieving a specified share price.

If the SPAC is determined to be the accounting acquirer, the entity should consider whether the earn-out is subject to the replacement award provisions of ASC 805¹² or is a new award under ASC 718. If the operating company is determined to be the accounting acquirer and the transaction is accounted for as a reverse recapitalization, the entity should determine whether the earn-out represents a change to a share-based payment arrangement that requires modification accounting under ASC 718 or a new award under ASC 718 in connection with the transaction.

For more information, refer to our FRD publication, [*Share-based payment*](#).

Reallocation of forfeitable shares

Earn-out arrangements may be granted to both employees and selling shareholders. If employees are required to provide services to participate in an earn-out arrangement, that earn-out arrangement is in the scope of ASC 718. The combined entity should determine whether any forfeiture of employees' earn-out shares could affect the number of shares issuable to the remaining employees and/or to selling shareholders (whose arrangement is accounted for under ASC 815-40). If the settlement amount of the earn-out arrangement with the selling shareholders is adjusted based on employment status (e.g., employees' forfeited shares are reallocated to the pool of earn-out shares to be issuable to selling shareholders who are not employees), that arrangement may not be considered indexed to an entity's own stock under ASC 815-40. If forfeited shares are reallocated to ASC 718 grantees, this is considered a "last-man-standing" arrangement, and the forfeiture and subsequent reallocation of the earn-out shares are accounted for as the forfeiture of the original award and the grant of a new award.

The reallocation of forfeited shares of employees in an earn-out could preclude equity classification under ASC 815-40.

Illustration 6 – Earn-out arrangement – reallocation of forfeited shares among remaining employees and selling shareholders

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the combined entity may issue up to 4,000,000 additional Class A shares to the OpCo X selling shareholders (who are not employees) and to employees of OpCo X that hold vested and unvested stock options. The shares will be issued if certain share-price thresholds of the combined entity are met within five years from the consummation date of the merger. The triggering events are as follows:

- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$12, 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$15, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$18, another 1,000,000 shares are issued.
- ▶ If VWAP over 20 out of 30 consecutive trading days meets or exceeds \$20, another 1,000,000 shares are issued.
- ▶ If an employee is no longer employed at the time any of the share-price targets are met, his or her shares will be reallocated among the selling shareholders and remaining employees who are entitled to the earn-out payment.

Because employees must be employed at the time the share-price triggers are met to receive the earnout shares, the arrangement with employees is accounted for under ASC 718. The arrangement with the selling shareholders is accounted for under ASC 815-40. If some employees forfeit their earn-out by terminating their service before a share-price trigger is reached, the earn-out shares originally granted to those employees are reallocated among the selling shareholders and remaining employees who are entitled to receive an earn-out payment.

When employees receive additional earn-out shares in the reallocation, this is considered a "last-man-standing" arrangement, which is accounted for as a forfeiture of the original award and a grant of a new award.

Because the settlement amount to be paid to the selling shareholders can change based on whether the employees who would otherwise be entitled to earn-out shares remain employed, the arrangement with the selling shareholders is not considered indexed to an entity's own stock under Step 2 of the indexation guidance. That's because the employment status of a grantee is not an input to the fair value of a fixed-for-fixed forward or option on equity shares. As a result, the earn-out arrangement with the selling shareholders would be classified as a liability.

Earn-out arrangements – EPS

Shares that could be issued pursuant to an earn-out arrangement are considered contingently issuable shares in EPS calculations. Under ASC 260, contingently issuable shares are treated differently for basic and diluted EPS. For basic EPS, contingently issuable shares are considered outstanding common shares and included in basic EPS *as of the date* that all necessary conditions have been satisfied (i.e., when issuance of the shares is no longer contingent on any conditions except the passage of time). If the contingency has been satisfied, such shares are to be considered outstanding for basic EPS computations, even if the shares physically have not been issued. If shares are returnable or placed in escrow until the shares are vested or some other contingent criteria (other than the passage of time) are met, the shares should be excluded from the denominator in computing basic EPS even if they have been issued.

For diluted EPS, when all the necessary conditions have been satisfied, those shares should be included in the denominator of the diluted EPS calculation *as of the beginning of the period* in which the conditions are satisfied or as of the inception date of the contingent stock arrangement, if later. Before the end of the contingency period, the number of contingently issuable shares included in diluted EPS is based on the number of shares, if any, that would be issuable under the terms of the arrangement if the end of the reporting period were the end of the contingency period, assuming the result would be dilutive.

If the earn-out arrangements give the holders a nonforfeitable right to dividends before the resolution of the contingency, they represent participating securities, regardless of whether the SPAC actually declares or pays dividends, and the use of the two-class method for calculating EPS would be required.

For further discussion of contingently issuable shares and participating securities, see sections 3.3.2, 4.8 and 5.2 of our FRD publication, [*Earnings per share*](#).

How we see it

Entities may reach different conclusions about whether to include potential common shares relating to earn-out arrangements in the denominator in the calculation of diluted EPS when shares are issuable upon achievement of a share-price target over a specified time period (e.g., 20 of 30 consecutive trading days). One acceptable approach would be to exclude the potential shares from the diluted EPS calculation until the condition has been met (i.e., the threshold share price has been met or exceeded for 20 of 30 consecutive trading days). Another acceptable alternative would be to include the potential shares in the diluted EPS calculation if the share price at the end of the reporting period equals or exceeds the threshold price under the assumption that the share price will not change before the end of the contingency period. Entities should disclose how they treat potential shares relating to earn-out arrangements in their diluted EPS calculations.

Transaction costs

The SPAC may incur various acquisition-related costs in connection with the de-SPAC transaction. They include:

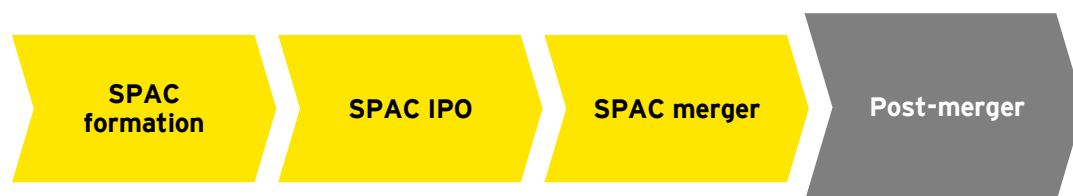
- ▶ Direct costs of the transaction, such as costs for the services of lawyers, investment bankers, accountants and other third parties
- ▶ Indirect costs of the transaction, such as recurring internal costs (e.g., the cost of maintaining an acquisition department)

The accounting for these costs depends on whether the SPAC or the operating company is identified as the accounting acquirer. If the SPAC is determined to be the accounting acquirer and the target company meets the definition of a business in ASC 805 (i.e., the transaction is accounted for as a forward merger), transaction costs are expensed as incurred pursuant to ASC 805. If the operating company is determined to be the accounting acquirer and the transaction is accounted for as a reverse recapitalization, qualifying transaction costs (i.e., direct and incremental costs in connection with the merger transaction) are accounted for differently from those incurred in a forward merger.

For reverse recapitalizations, we understand that the SEC staff views these transactions as the issuance of equity by the accounting acquirer for the cash of the SPAC.¹³ Accordingly, direct and incremental transaction costs related to the SPAC merger that wouldn't otherwise have been incurred are treated as a reduction of the SPAC's cash proceeds, and they are deducted from the combined company's additional paid-in capital rather than expensed as incurred. This treatment is similar to the treatment described in SEC Staff Accounting Bulletin Topic 5.A.

Frequently, the combined entity may issue new financial instruments (e.g., earn-out arrangements) or assume financial instruments (e.g., warrants that were issued by the SPAC) as part of the reverse recapitalization. We generally believe an allocation of these costs to the individual instruments issued and assumed in the transaction is appropriate. Generally, costs allocated to equity-classified instruments (e.g., SPAC shares) are recorded as a reduction to additional paid-in capital. Costs allocated to liability-classified instruments that are subsequently measured at fair value through earnings (e.g., certain SPAC warrants) are expensed. Refer to the [Issuance costs](#) section above for a detailed discussion on allocation of issuance costs.

Post-merger



After a de-SPAC transaction, the combined entity may be faced with several accounting issues. For example, if the entity decides to redeem its public warrants and/or private placement warrants, it will need to determine the appropriate accounting for the redemptions. Likewise, events such as the transfer of a private placement warrant to a non-affiliate of the sponsor or a change in the combined company's capital structure will also require the combined entity to consider the accounting implications.

Private placement warrants transferred to a non-affiliated party

Because private placement warrants become public warrants when they are transferred to an entity that isn't affiliated with the sponsor, such a transfer requires a reassessment of the warrant's classification. This is necessary because certain provisions of private placement warrants (discussed in the [SPAC warrant, including public warrants](#) section above) that may have caused the warrants to be classified as liabilities under ASC 815-40 could be resolved upon the transfer.

For example, private placement warrants typically are not subject to the \$0.01 redemption feature, which causes them to fail Step 2 of the indexation guidance (because of differences in settlement amounts based on the holder of the warrant) and results in liability accounting. That's no longer the case once the warrants are transferred to a non-affiliated party and become public warrants.

If the private placement warrants were classified as liabilities under ASC 815-40, and if the public warrants are classified in equity, the former private placement warrants should be reclassified to equity upon their transfer to a non-affiliate of the sponsor. Upon reclassification, the carrying amount of the private placement warrant liability (after the last mark to fair value the day they are transferred) is derecognized and credited to equity.

Changes in the combined company's capital structure

The combined entity may change its capital structure by issuing a new class of voting securities (e.g., voting preferred stock) or converting from a dual-class capital structure to a single-class capital structure if that change isn't automatic when the merger occurs. These changes require reassessment of the classification of warrants issued by the SPAC pursuant to ASC 815-40-35-8. That guidance says the classification conclusion could change due to changes in the issuer's capital structure or other similar transactions.

ASC 815-40-35-8 also says that if reclassification is required, the instrument should be reclassified as of the date of the event that caused the reclassification. The instrument would be marked to its fair value on the date of the reclassification.

Endnotes:

- ¹ ASC 480, *Distinguishing Liabilities from Equity*.
- ² ASC 718, *Compensation – Stock Compensation*,
- ³ ASC 480-10-S99, *Distinguishing Liabilities from Equity – Overall – SEC Materials*.
- ⁴ ASC 815, *Derivatives and Hedging*.
- ⁵ ASC 815-40, *Derivatives and Hedging – Contracts in Entity's Own Equity*.
- ⁶ 2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments – *Compendium of significant accounting and reporting issues*.
- ⁷ ASC 260, *Earnings Per Share*.
- ⁸ Footnote 17 of ASC 480-10-S99-3A.
- ⁹ SEC Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"), issued by John Coates, Acting Director, Division of Corporation Finance, and Paul Munter, Acting Chief Accountant, on 12 April 2021.
- ¹⁰ This is applicable to entities that have adopted Accounting Standards Update 2020-06, *Debt – Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging – Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*. US GAAP does not currently provide subsequent measurement guidance for these instruments, and some entities carry them at cost.
- ¹¹ ASC 450, *Contingencies*.
- ¹² ASC 805, *Business Combinations*.
- ¹³ SEC Division of Corporation Finance's *Financial Reporting Manual*, Section 12100.