

CAQ Alert 2021-01:

Auditor and Audit Committee Considerations Relating to Special Purposes Acquisition Company (SPAC) Initial Public Offerings and Mergers

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Special purpose acquisition companies (SPACs) have been used for decades as a mechanism for private companies to access capital markets. Recently, SPACs **exploded** in popularity from just 59 SPAC IPOs in 2019 to more than 300 SPAC IPOs in the first few months of 2021. The creation of a SPAC and subsequent merger of a SPAC and a target company often raises complex accounting, financial reporting and governance issues. This Alert provides an overview of what a SPAC is and some key considerations for auditors and audit committees related to the unique risks and challenges of a private company entering the public markets through a merger with a SPAC. The lists of considerations below are not intended to be all inclusive.¹ In addition, while these considerations are intended for auditors and audit committees, members of management may also find them helpful.

¹ The information in this Alert relates to SPAC transactions involving domestic entities; additional considerations could apply when foreign entities are involved.

WHAT IS A SPAC?

+ A SPAC is a shell company formed for the purpose of raising funds to be used in connection with the acquisition of an existing operating company. The acquired company is the target company.

+ Five phases of a SPAC lifecycle:²

1. *Formation.* A SPAC is formed by sponsors, who are founding investors that lead the SPAC process.
2. *IPO.* After formation, a SPAC raises capital through an Initial Public Offering (IPO) and proceeds are placed in a trust account while the SPAC identifies and acquires a target company. The SPAC is a shell company with no operations (other than acquisition activities and related expenses) and no assets (other than the capital raised in the IPO process).
3. *Target Search.* The SPAC typically tries to acquire a target company in a specific industry or geographic location. Depending upon provisions in the governing documents, the SPAC has a limited amount of time to identify and acquire a target company (typically 18 to 24 months). If a target company is not identified and acquired within the stipulated time period, the SPAC is liquidated, and proceeds are returned to the shareholders.
4. *Shareholder Vote.* Once a target company has been identified, shareholder approval is typically required before consummation of the merger. Shareholders may also elect to redeem their shares. Therefore, the consummation of a merger typically requires entities to file a proxy statement with the SEC, obtain and respond to the SEC's comments, provide the proxy statement to the SPAC's shareholders, and hold a shareholder meeting.
5. *Merger or "De-SPAC" Transaction.* Once a target company is identified and shareholder

FIVE PHASES OF A SPAC LIFECYCLE

1 **FORMATION**

2 **IPO**

3 **TARGET SEARCH**

4 **SHAREHOLDER VOTE**

5 **MERGER OR "DE-SPAC" TRANSACTION**

approval has been obtained, the SPAC and the target undertake a merger, acquisition or other transaction. In most cases, this results in the operating business becoming a publicly traded company that effectively "takes over" the public company status of the SPAC. As a result of this process, the SPAC is "de-SPACed" and continues its life as a public company.³

While the use of a SPAC can offer certain advantages such as quicker access to the capital markets, it also can present numerous challenges. For example, post-merger/acquisition, the target company is subject to the same complex legal and accounting requirements as a company that went through a traditional IPO, but in a shorter time period (usually in a matter of a few months).

² Source: <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-private-company-CFO-considerations-for-SPAC-transactions.pdf>

³ Source: https://www.allenoverly.com/global/-/media/allenoverly/2_documents/news_and_insights/publications/2020/10/the_journey_to_de-spacing_and_beyond_key_securities_law_considerations_for_former_spacs.pdf

CONSIDERATIONS FOR AUDITORS

In its statement on [Financial Reporting and Auditing Considerations of Companies Merging with SPACs](#), the SEC staff indicated that it is critical that the board of directors, audit committees (as applicable), management, and auditors of operating companies involved in a merger with a SPAC fully understand and fulfill their professional responsibilities so that companies meet their obligations under the federal securities laws and investors are provided with high quality financial reporting at the time of the merger and on an ongoing basis. Highlighted below are some considerations for auditors related to SPAC merger transactions:

- + Client Acceptance and Continuance:** As part of the auditor's client acceptance and continuation procedures, have the following been considered for a SPAC and/or a private target company audit client preparing to go public through a SPAC merger?

 - Capabilities of Management:** The financial statement requirements for a SPAC merger transaction are largely consistent with the requirements for a traditional IPO. Does management have the skillset(s) needed, or the ability to obtain such skillset(s), to comply with the SEC's financial statement reporting requirements and deadlines, including the need to "unwind" any historically applied private company GAAP alternatives created by FASB and its Private Company Council or to adopt standards that were not effective for private companies? Has management considered the skills needed for financial reporting complexities that may not have been previously encountered, such as the accounting for business combinations, redeemable shares, earnings per share, earn-out arrangements, warrants, and the preparation of pro forma financial statements? Other capabilities of management of the target company to consider include whether they are familiar and have experience with:

 - ▶ Budgeting and forecasting?
 - ▶ Tax planning and strategy?
 - ▶ Information technology?
 - ▶ National securities exchange listing requirements?
- Internal Controls/Books and Records:** Does the post-merger entity have (or have the ability and skillset to implement) a system of internal control over financial reporting (ICFR) that complies with public company requirements? Are there material weaknesses that warrant disclosure? If so, does the entity have the ability to respond to the material weaknesses and enhance its ICFR? Is the entity in compliance with the books and records provisions of the Foreign Corrupt Practices Act? Is the company preparing to comply with the requirements of the Sarbanes-Oxley Act (SOX) Sections 302, 404 and 906 as applicable after the merger?⁴
- Timing Considerations:** Does the target company have a comprehensive plan in place to address the demands of becoming a public company on an accelerated timeline?
- Auditor Independence:** Auditor independence is foundational to the credibility of the audited financial statements, and is a shared responsibility among audit committees, management, and the auditor. Is the audit firm in compliance with both PCAOB and SEC independence requirements? Does the audit engagement pose conflicts for the auditor in terms of compliance with the SEC's auditor independence rules? Have partner rotation requirements been considered? Has the permissibility of non-audit services and prior involvement in the preparation of the financial statements of the target company been considered? Have processes been established for the pre-approval by the audit committee of the auditor's services?
- Capabilities of Audit Engagement Team:** Has the auditor re-evaluated the skills and experience of the audit engagement team to determine whether it should be augmented or changed to include members with the appropriate level of expertise and experience in audits of SEC registrants under PCAOB standards? Does the auditor have the capacity to complete the audit for the merger transaction and continue to perform audits and reviews of the surviving company? Are there anticipated accounting issues that may arise in connection with the merger that should be

⁴ Generally, these sections relate to management certifications and management and auditor assessment of the effectiveness of ICFR.

considered in assessing whether the audit engagement team has appropriate expertise and experience? For example, issues relating to complex financial instruments, valuation, business combinations, EPS, share-based payments and segments might not have existed when the target company was privately held.

- **Corporate Governance:** Is the post-merger entity prepared to comply with the requirements of the exchange on which it is listed (e.g., NYSE and Nasdaq require independent directors and an audit committee, including an audit committee financial expert)? If not, do they have the ability to have them in place prior to consummation of the transaction?
- + **Auditor Registration with the PCAOB:** Auditors of SPACs and their target companies must be registered with the PCAOB and perform their audits in accordance with standards of the PCAOB. Is the auditor in compliance with these requirements?
- + **Auditor Reporting:** Consider whether the auditor is required to perform the engagement and issue a report under both PCAOB and AICPA standards. Has the auditor considered the applicability of reporting critical audit matters (after considering whether the SPAC and target company would each qualify for the exemption as an Emerging Growth Company), auditor tenure disclosure, and compliance with the PCAOB audit transparency (Form AP) rules (including an evaluation of whether other firms who participate in the audit meet the substantial role criteria)?
- + **Disclosure Considerations:** On December 22, 2020, the SEC's Division of Corporation Finance issued [CF Disclosure Guidance: Topic No. 11](#) which provides guidance on certain disclosure considerations for SPACs in connection with their initial public offerings and subsequent business combination transactions. Has the auditor discussed this guidance with management and understood management's considerations?

+ **Classification of Warrant Provisions:** Has management addressed the classification of warrants issued by the SPAC in accordance with the guidance in the recent [Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies \("SPACs"\)](#) and Accounting Standard Update (ASU) No. 2021-04, *Earnings Per Share (Topic 260), Debt— Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging— Contracts in Entity's Own Equity (Subtopic 815-40: Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (A Consensus of the Emerging Issues Task Force))*? If the registrant determines a warrant is a liability, has the auditor considered the need/expertise to audit the fair value estimate of the warrants?

+ **Elevated Risk of Fraud:** Has the auditor considered risk factors or conditions that could heighten fraud risk, such as overly optimistic forecasts or pressure to achieve earnings or stock price targets?

CONSIDERATIONS FOR AUDIT COMMITTEES

Audit committee oversight is critical prior to, during, and after a SPAC merger transaction. They will need to execute the shared responsibility of assessing auditor independence, overseeing the public company's financial reporting and ICFR requirements, and overseeing the external audit.

Communication among the audit committee, management and the external auditor is essential throughout the lifecycle of the merger and beyond. Audit committees should engage with the external auditor and understand the considerations for auditors noted above. Audit committees should be aware that during period January 1, 2015 – June 30, 2020⁵ an average of 38% of the SPAC merger filings disclosed a material weakness in ICFR.

5 Source: <https://www.pwc.com/us/en/services/deals/library/assets/pwc-material-weakness-disclosures-in-an-ipo.pdf>

6 Source: <https://boardleadership.kpmg.us/content/dam/boardleadership/en/pdf/2020/questions-for-board-with-spac-in-sight.pdf>

In addition, audit committees of private companies determining whether to “go public” via a SPAC transaction should consider:⁶

+ Public Company Readiness: Is the company ready for, or do they have a plan in place related to:

- Financial Reporting Expertise
 - ▶ Complying with incremental SEC reporting disclosure requirements and deadlines?
 - ▶ Dealing with complex accounting and valuation issues, including engaging with specialists as necessary?
 - ▶ Engaging with attorneys that have appropriate SEC experience?
- Internal Controls
 - ▶ Management’s assessment of ICFR and management certifications?
 - ▶ Independent external audits of the financial statements and ICFR (if applicable) in accordance with standards of the PCAOB and independence requirements of the PCAOB and SEC?
- Investor relations, including earnings releases and calls, forecasting and budgeting capabilities?
- Executive compensation plan considerations?
- Tax considerations?

+ SPAC Sponsor Experience: Does the SPAC leadership have a track record in completing a SPAC transaction? Does the SPAC leadership have expertise in the industry or geography of the target company?

+ Corporate Governance: What is the board composition of the company post-merger? Do board members have the right diversity of skillsets, level of experience and independence including those on the audit committee? Does the company have an internal audit function? Does the company have a whistleblower complaint process in place as required by SOX?

+ Accounting, Reporting, and Disclosure Issues: Does the audit committee understand management’s plans and processes to “de-SPAC”? Has management considered whether to seek pre-clearance from the SEC with respect to complex accounting issues? Have controls been established regarding the transition and how will they be monitored?

+ External Auditor Selection and Oversight: Do the external auditors have the right experience? Are they registered with the PCAOB? Do they meet SEC and PCAOB independence requirements?

RESOURCES

SEC

- + [Division of Corporation Finance Disclosure Guidance: Topic No. 11](#)
- + [Financial Reporting and Auditing Considerations of Companies Merging with SPACs](#)
- + [Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies](#)
- + [SPACs, IPOs and Liability Risk under the Securities Laws](#)
- + [Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies \("SPACs"\)](#)

BDO

- + [BDO Knows SPACs Resource Page](#)

Crowe

- + [A Guide to Going Public and Living as a Public Company](#)

Deloitte

- + [Private-Company CFO Considerations for SPAC Transactions](#)
- + [Accounting and SEC Reporting Considerations for SPAC Transactions](#)
- + [How to plan for the first days as a public company after a SPAC merger](#)

EY

- + [What You Need to Know About SPACs](#)
- + [Technical Line - Navigating the requirements for merging with a special purpose acquisition company](#)

Grant Thornton

- + [Understanding the risks and rewards of a SPAC – What your company should know about the IPO alternative](#)
- + [Merging with a special purpose acquisition company \(SPAC\)](#)

KPMG

- + [SPAC insights: Public company readiness](#)
- + [SPACs: Are you really ready to commit?](#)

PwC

- + [In depth: Domestic SPAC mergers – financial reporting and accounting considerations](#)
- + [In the loop: What's behind the SPAC-tacular boom of 2020?](#)

RSM

- + [SPAC Resource Center](#)

AUDIT COMMITTEE RESOURCES

KPMG

- + [Questions for the board with a SPAC in sight](#)

PwC

- + [Understanding the SPAC trend – What corporate boards need to know](#)

RSM

- + [Board perspectives when considering a transaction with a SPAC](#)