Special Purpose Acquisition Companies (SPACs): Accounting for Warrants at Acquisition

Extract, IFRS® Discussion Group Report on the Meeting – May 19, 2022

The IFRS Interpretations Committee (the Interpretations Committee) received a request about how an entity accounts for warrants when acquiring a SPAC. A SPAC is a listed entity that is established to acquire a yet-to-be-identified target entity.

In the fact pattern described in the submission:

- A private operating entity acquires a SPAC that does not meet the definition of a business in IFRS 3 *Business Combinations* and has no assets other than cash.
- Before the acquisition, the SPAC's ordinary shares, which are determined to be equity instruments as defined in IAS 32 *Financial Instruments: Presentation*, were held by its founder shareholders and public investors. The SPAC also issued warrants to both its founder shareholders and public investors (the SPAC warrants).
- The private entity acquires the SPAC by issuing new ordinary shares and warrants in exchange for the SPAC's ordinary shares and the legal cancellation of the SPAC's warrants. The SPAC becomes a wholly owned subsidiary of the entity, and the entity replaces the SPAC as the entity listed on the stock exchange.
- The fair value of the instruments the entity issues to acquire the SPAC exceeds the fair value of the identifiable net assets of the SPAC.

The request asked whether the warrants issued to the SPAC shareholders are in the scope of IFRS 2 *Share-based Payment* as part of the equity instruments issued, or whether they represent a liability assumed by the acquiring company. If the warrants are classified as equity instruments, the request asked how they should be accounted for following the acquisition. The Interpretations Committee discussed this issue at its March 2022 meeting. Subsequent to the meeting, the Interpretations Committee published a tentative agenda decision on this issue.

The tentative agenda decision includes the following key points:

- Based on the fact pattern presented, the entity is the acquirer and the acquisition of the SPAC (acquiree) is the acquisition of an asset or a group of assets that does not meet the definition of a business.
- The entity considers the specific facts and circumstances of the transaction in assessing whether it assumes the SPAC warrants as part of the acquisition. If the facts and circumstances are such that the entity assumes the SPAC warrants as part of the acquisition, the entity applies IAS 32 to determine whether the warrants are financial liabilities or equity instruments. In addition, the entity considers the extent to which it accounts for the replacement of the SPAC warrants as part of the acquisition.
- The stock exchange listing service does not meet the definition of an intangible asset because it is not "identifiable" as described in paragraph 12 of IAS 38 *Intangible Assets*. Paragraph 2 of IFRS 2 states that "an entity shall apply this IFRS in accounting for all share-based payment

transactions, whether or not the entity can identify specifically some or all of the goods or services received." The Interpretations Committee observed that:

(a) the entity receives a stock exchange listing service for which it has issued equity instruments as part of a share-based payment transaction; and

(b) per paragraph 13A of IFRS 2, the entity measures the stock exchange listing service received as the difference between the fair value of the instruments issued to acquire the SPAC and the fair value of the identifiable net assets acquired.

- The Interpretations Committee tentatively concluded that the entity applies:

  (a) IFRS 2 in accounting for instruments issued to acquire the stock exchange listing service; and

  (b) IAS 32 in accounting for financial instruments issued to acquire cash and assume any liabilities related to the SPAC warrants because these instruments were not issued to acquire goods or services.

- If the entity concludes that the facts and circumstances are such that it does *not* assume the SPAC warrants as part of the acquisition, the entity issues both ordinary shares and warrants to acquire cash and a stock exchange listing service. In this case, the entity determines which instruments it issued to acquire the cash and which instruments it issued to acquire the listing service.

- IFRS Standards do not specify how to allocate the ordinary shares and warrants issued to acquire cash and stock exchange listing services. Therefore, the entity applies paragraphs 10-11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in developing and applying an accounting policy. Paragraph 10 of IAS 8 specifies, "In the absence of an IFRS that specifically applies to a transaction, other event or condition, management shall use its judgement in developing and applying an accounting policy that results in information that is: (a) relevant to the economic decision-making needs of users; and (b) reliable." The Interpretations Committee noted that:

  (a) an accounting policy that results in allocating all the warrants issued to the acquisition of the stock exchange listing service solely to avoid the warrants being classified as financial liabilities applying IAS 32 would not meet this requirement;

  (b) the entity could allocate the shares and warrants to the acquisition of cash and the stock exchange listing service based on relative fair values of the instruments issued (i.e., in the same proportion as the fair value of each type of instrument to the total fair value of all issued instruments); and

  (c) other allocation methods could be acceptable if they meet the relevance and reliability requirements in paragraphs 10-11 of IAS 8.

The Group considered the analysis included in this tentative agenda decision.

Issue 1: Practical challenges when applying an allocation approach to the consideration issued

Analysis

The tentative agenda decision introduces the notion of needing to determine which instruments were issued (shares or warrants under IAS 32 or IFRS 2) to acquire/assume specific items using an allocation approach. Allocating warrants partially to an IAS 32 transaction and partially to an IFRS 2 transaction may result in classifying the same instruments with the same terms partially as equity and partially as liability instruments due to the differences between how financial instruments are classified under each standard. For example, under IAS 32, warrants that may be settled other than by the exchange of a fixed amount of cash for a fixed number of the entity's own equity instruments would be classified as a liability. Under IFRS 2, the same warrants would be classified as equity.

The tentative agenda decision also does not address the practical difficulties that may arise with the subsequent accounting for the new warrants issued and allocated to the acquisition of cash and to the stock exchange listing service. For example, as warrants are exercised over time and where the terms and conditions of the exercised warrants and those of non-exercised warrants are the same, it may be difficult for the entity to distinguish which warrants are in fact exercised.

The Group's Discussion

Most Group members thought that the technical analysis in the tentative agenda decision had merit. However, several Group members noted that classifying consideration transferred (the warrants issued in the transaction) between IFRS 2 and IAS 32 depending on the underlying asset or service acquired results in several application challenges. One Group member questioned whether this allocation would result in relevant and reliable information. Furthermore, they thought that it may be confusing if warrants with the same features are accounted for as liabilities under IAS 32 or equity in accordance with IFRS 2. This Group member also thought that the liability presented on the balance sheet would not be a faithful representation of the full liability incurred by the entity. Another Group member noted that this situation highlights the broader issue that some instruments with the same features may be classified differently under IFRS 2 versus IAS 32. This Group member also agreed with the analysis in the tentative agenda decision that allocating all the warrants issued to the acquisition of the stock exchange listing service solely to avoid the warrants being classified as financial liabilities would not meet the requirements in paragraphs 10-11 of IAS 8.

Issue 2: Potential implications of the tentative agenda decision to other transactions and scenarios

Analysis

The approach proposed in the tentative agenda decision of allocating the consideration issued between IFRS 2 and IAS 32 transactions might also apply to the acquisition of a group of assets that is not a SPAC. Common examples include the acquisition of patents, intellectual property, receivables, payables and cash from a company in the life sciences industry. This may result in a change in practice as historically many entities applied judgment in determining whether IFRS 2 or IAS 32 applied instead of allocating between the two standards.

Another scenario that this tentative agenda decision might apply to is the issuance of warrants to key management personnel. It is common in the private equity industry to award key management personnel a variable number of shares in exchange for cash consideration, with the warrants being callable if the manager does not meet certain service conditions. The tentative agenda decision might apply in this scenario, given that a warrant is issued by the entity for cash proceeds and services to be received in the future.

The Group's Discussion

Several Group members agreed that this tentative agenda decision might also impact the accounting for other types of transactions involving the issuance of warrants to acquire a group of assets and liabilities. They indicated that these types of transactions are typically accounted for in their entirety under IFRS 2, whether or not the entity acquires any financial instruments as part of the transaction. These Group members also indicated that these types of transactions are common in Canada. Therefore, this tentative agenda decision, if finalized, could have a significant impact on Canadian entities.

One Group member commented that if this tentative agenda decision is finalized, entities would need to consider paragraphs 2-6A of IFRS 2 as to the scope of that standard when determining which assets and liabilities are included in the accounting for share-based payment transactions.

Another Group member noted that this tentative agenda decision might also apply to capital pool companies (CPCs) that issue replacement warrants or stock options. They said that most CPCs currently refer to the replacement share-based payment guidance in IFRS 3 *Business Combinations* when accounting for these types of transactions.

One Group member noted that the issuance of warrants to key management personnel in exchange for cash consideration might not fit into the fact pattern in the tentative agenda decision and that additional analysis would be required to assess the appropriate classification of instruments issued in such transactions.

Issue 3: SPACs accounted for as reverse takeover transactions (RTO)

Analysis

The Interpretations Committee's March 2022 Agenda Paper included an analysis of a fact pattern in which the SPAC acquisition is structured as a reverse acquisition. However, this scenario was not included in the tentative agenda decision because it was not the fact pattern submitted to the Interpretations Committee. Therefore, any diversity in practice that exists today might continue.

The Agenda Paper stated that if a SPAC acquisition is structured as a reverse takeover acquisition and the entity does not replace the SPAC warrants with new warrants, the SPAC warrants survive the transaction. Consequently, the entity assumes the SPAC warrants as part of the acquisition and recognizes any liabilities related to those warrants. The entity would therefore apply IAS 32 in determining whether the SPAC warrants are financial liabilities or equity instruments.

In practice, some entities consider the SPAC warrants part of the deemed consideration for the acquisition of the SPAC. Such consideration would be in scope of IFRS 2 to the extent that they relate to the acquisition of goods or services.

The Group's Discussion

One Group member noted that there is currently diversity in practice in how entities account for warrants upon the reverse takeover of a SPAC. This Group member indicated that some entities might rethink their accounting policy after considering the analysis in the Interpretations Committee's March 2022 Agenda Paper.

Most Group members agreed that the allocation approach highlighted in the tentative agenda decision would result in a change in practice for many Canadian entities when accounting for the issuance of warrants to acquire a SPAC, as well as other similar asset acquisition transactions. Several Group members also questioned whether this approach would result in the most relevant and reliable information. Therefore, the Group recommended that the AcSB respond to the Interpretations Committee's tentative agenda decision[1].

[1] The AcSB considered the feedback from the Group and submitted a comment letter on this tentative agenda decision on May 20, 2022.