# STANDARD SETTING

***November 2022 update:***
This publication was issued prior to the finalization of the IFRIC agenda decision *Special Purpose Acquisition Companies (SPAC): Accounting for Warrants at Acquisition* in October 2022 and does not reflect the analyses in the agenda decision. Readers should refer to the said agenda decision when accounting for the related transactions.


# Accounting considerations for a Special Purpose Acquisition Company (SPAC)

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CPA
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# Foreword

In September 2021, the Hong Kong Stock Exchange ("HKEX") published a Consultation Paper in which it proposed to amend the listing rules to introduce a listing regime for Special Purpose Acquisition Companies ("SPACs") in Hong Kong. The related Consultation Conclusions was published in December 2021 and the regime became effective from 1 January 2022.[1]

The structure and lifecycle of a typical SPAC give rise to various complex financial reporting issues. Practice is developing as these issues continue to evolve. This publication highlights certain key accounting considerations that have come to our attention at the time of writing that may be relevant to a SPAC throughout its lifecycle. Given the newly established SPAC regime in Hong Kong, this publication draws on the experience of other jurisdictions with active SPAC listings (e.g. the US and Singapore) and describes common accounting issues faced by a *typical* SPAC.

Readers should take note of the relevant listing rules stipulated by the HKEX, the provisions of the SPAC's own constitutional documents, shareholders' agreements as well as applicable laws and regulations when assessing the accounting treatment of the various issues noted in this publication and other issues that may arise. Readers are also advised to seek professional advice where necessary.

We hope you will find this publication useful.

Cecilia Kwei
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January 2022

[1] https://www.hkex.com.hk/News/Regulatory-Announcements/2021/211217news?sc_lang=en

# 1. Structure and lifecycle of a typical SPAC

A SPAC is a shell company whose sole purpose is to raise funds through an initial offering[2] ("IPO") and to acquire an operating company within a pre-defined period after listing, usually within 18-24 months. SPACs typically do not have business operations and do not have assets other than (a) the proceeds from their IPOs and (b) the initial capital raised from SPAC promoters to pay for the SPAC's initial expenses. In terms of Chapter 18B of the HKEX Main Board Listing Rules ("Listing Rules" / "LR"), the IPO proceeds are held in an escrow account until the SPAC acquires a target operating company ("De-SPAC Target") or until such time as the investors request redemption of their shares upon various events.

Once the SPAC has identified a De-SPAC Target, its management team will negotiate with the De-SPAC Target and execute the acquisition as approved by the SPAC shareholders. The acquisition is usually structured as a reverse acquisition in which the De-SPAC Target merges with the SPAC or becomes a subsidiary of the SPAC. While there are different ways to structure the acquisition transaction, the resulting group or combined entity ("Successor Company") is a listed entity and carries on the De-SPAC Target's original business activities. The acquisition transaction is often referred to as the SPAC merger or the de-SPAC transaction ("De-SPAC Transaction").

If the SPAC does not complete the De-SPAC Transaction within the prescribed timeframe (including any extension), the SPAC will be required to return the IPO proceeds (at a minimum) held in the escrow account to the investors. The SPAC will then be delisted. Liquidation may follow but it is not a requirement under the Listing Rules.

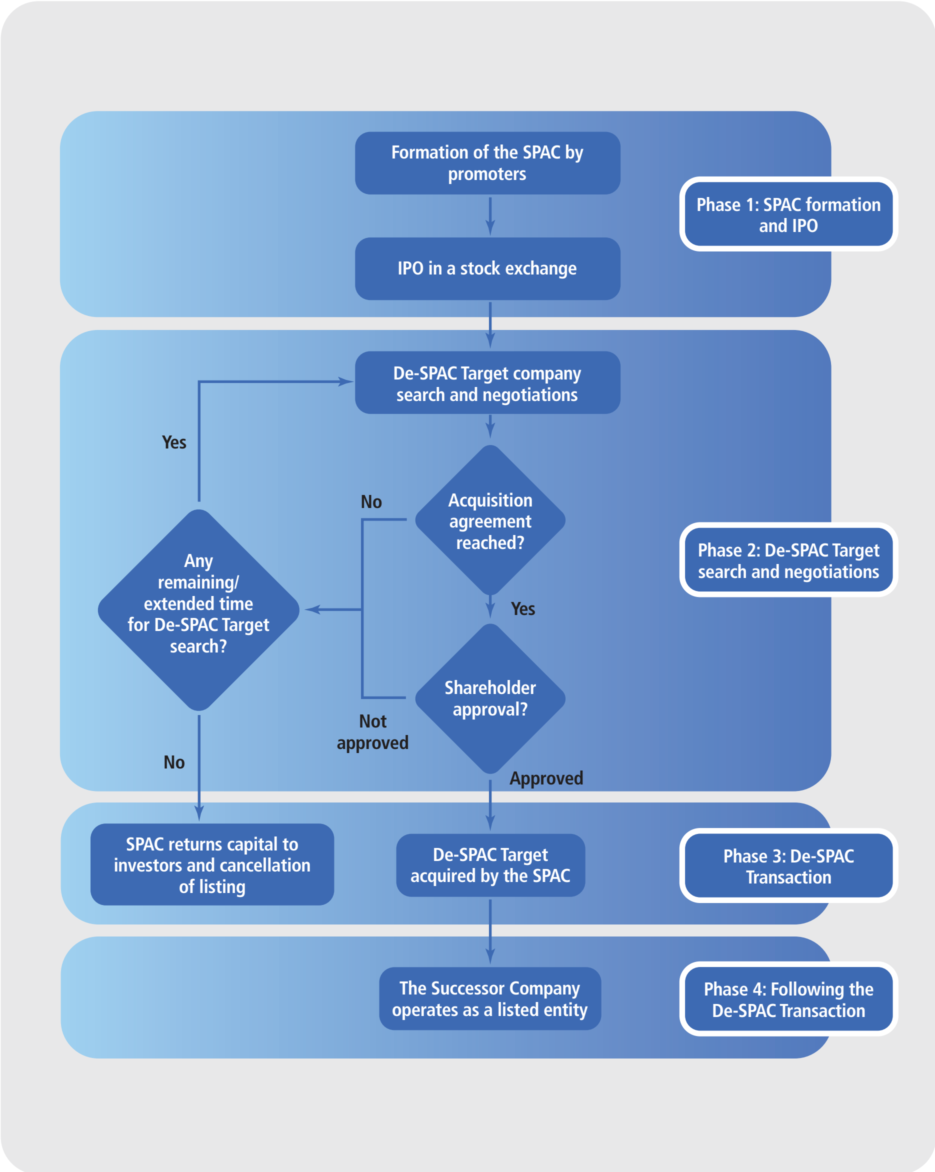
The typical lifecycle of a SPAC is illustrated overleaf.

As can be seen from the diagram, a typical SPAC's lifecycle can be broken down into three stages:

1. Prior to the De-SPAC Transaction. This incorporates the first two phases i.e. SPAC formation, IPO, De-SPAC Target search and negotiations;
2. The De-SPAC Transaction; and
3. Following the De-SPAC Transaction.

[2] SPAC Shares and SPAC Warrants can only be offered to Professional Investors in terms of Chapter 18B of the Listing Rules (capitalised terms as defined in the Listing Rules).

The accounting considerations at each stage are discussed below.



## 2. Prior to the De-SPAC Transaction

This includes Phase 1 *SPAC formation and IPO* as well as Phase 2 *De-SPAC Target search and negotiations*.

At the time of formation, the SPAC often issues various kinds of financial instruments such as promoter shares ("Promoter Shares") and promoter warrants ("Promoter Warrants") to the promoters.

Upon IPO, the SPAC usually issues public shares ("SPAC Shares") and public warrants ("SPAC Warrants", together with Promoter Warrants, "Warrants") of the SPAC to external investors. In terms of the Listing Rules, SPAC Shares and SPAC Warrants are issued and traded separately under their own unique trading symbols. The IPO proceeds are held in an escrow account and earn interest while the SPAC conducts the De-SPAC Target search.

Prior to the De-SPAC Transaction, the SPAC usually has a limited number of financial statement balances as it has minimal activities. The financial statements of the SPAC comprise mainly cash raised from the IPO and from the promoters, shareholders' funding (equity and/or liability) as well as general and administrative expenses incurred for the De-SPAC Target search.

The accounting for the Promoter Shares, SPAC Shares and Warrants could be complex and may require significant judgement. The key questions are (1) which standard applies (e.g. HKFRS 2 *Share-based Payment* or HKAS 32 *Financial Instruments: Presentation*), and (2) whether these instruments should be classified as liabilities, equity or compound instruments in the SPAC's financial statements. The table below describes the commonly seen features and the relevant accounting considerations for these instruments.

## Promoter shares

### Commonly seen features

- The SPAC may issue Promoter Shares to promoters at its formation in exchange for a nominal amount of cash, for services or for both.
- The promoters usually have significant experience with SPAC transactions and provide significant support to the SPAC in terms of the IPO, target search, negotiation and consummation of the deal. The promoters also typically hold management or board positions at the SPAC.
- Generally, Promoter Shares have similar voting rights as SPAC Shares except they may have the additional right to elect directors of the SPAC.
- Promoter Shares convert into SPAC Shares upon completion of the De-SPAC Transaction.
- Promoter Shares are not redeemable.

### Accounting considerations

- Given the significant services provided by the promoters to the SPAC, it is critical to assess whether the Promoter Shares are given to these individuals in return for services received by the SPAC (in the scope of HKFRS 2) or in their capacity as shareholders (in the scope of HKAS 32).
- This assessment should take into account all relevant facts and circumstances and may require significant judgment. Some relevant considerations include the following (the presence or absence of any individual indicators is not determinative):

  a. What is the commercial rationale for issuing the Promoter Shares?
  b. Do the promoters have an obligation to provide services for free or below market value in exchange for the Promoter Shares?
  c. Are the Promoter Shares subject to any service or vesting conditions, including implicit conditions?
  d. Is the remuneration received by the Promoter Shareholders (apart from the Promoter Shares) commensurate with the services rendered by them to the SPAC?
  e. What would happen to the Promoter Shares if the promoters left the SPAC or if the De-SPAC Transaction does not happen?
  f. Are there any additional rights attached to the Promoter Shares compared to the SPAC Shares?

- In many cases it is likely that the Promoter Shares will fall within the scope of HKFRS 2. In this case, the share-based payment would be classified as equity-settled or cash-settled depending on the terms of the arrangement. The fair value of equity-settled share-based payments is measured at the grant date and is not subsequently remeasured. For cash-settled share-based payments, the fair value of the liability is remeasured at the end of each reporting period up to the date of settlement.
- Under HKFRS 2, management will need to assess what the appropriate grant date and vesting period is, as well as whether the conditions attached are vesting or non-vesting conditions and how they will affect the grant date fair value of the Promoter Shares (and subsequent reporting date fair value for cash-settled share-based payments), amongst other things.
- HKAS 32 specifically scopes out transactions that are within the scope of HKFRS 2. If the Promoter Shares are indeed within the scope of HKAS 32, their classification will be driven by whether the conversion into SPAC Shares meets the requirement in HKAS 32.16(b). Management should also consider whether the SPAC is a limited life company in making this assessment.
- Another point to note is that if the Promoter Shares are convertible into SPAC Shares at a time when the latter are classified as financial liabilities (at least in part), the Promoter Shares will also be classified as financial liabilities.

## SPAC Share

### Commonly seen features

- SPAC Shares are typically redeemable regardless of whether a De-SPAC Transaction occurs:
  - prior to a general meeting to approve a De-SPAC Transaction, the shareholders may elect to redeem the shares for cash in case they do not want to invest in the De-SPAC Target, with the completion of the redemption being subject to approval and completion of the De-SPAC Transaction;[3]
  - if no De-SPAC Transaction is completed within the prescribed period (including any extension), the SPAC will be required to return the IPO proceeds to all the holders of SPAC Shares, which will in effect become mandatorily redeemable.

[3] In terms of the Listing Rules, two other events requiring shareholders' approval at a general meeting will trigger a redemption right: (i) continuation of the SPAC following a material change in certain SPAC Promoter or SPAC directors, and (ii) extension of the deadlines relating to the announcement or completion of a De-SPAC Transaction.

- In terms of Listing Rule 18B.57, the redemption price of each SPAC Share is at least equal to the price at which it was issued at the SPAC's IPO.
- SPAC Shares typically have dividend and voting rights, including the right to approve any proposed acquisitions.
- The detailed terms of the SPAC Shares can vary substantially among different SPACs. For example, the SPAC Shares may or may not provide interest return to the investor if no De-SPAC Transaction occurs; the voting mechanisms for approving the De-SPAC Transaction and/or extending the De-SPAC timeframe could vary, or the redemption right may be exercisable at different times.

**Accounting considerations**

- Management should consider whether the SPAC is a limited life company in light of the Listing Rule requirements, together with other relevant laws and regulations, constitutional documents of the SPAC and shareholder agreements. Further consideration should be given to whether the SPAC Shares meet the criteria in HKAS 32.16A to 16D to be presented as equity.
- Given the redemption features of SPAC Shares, the SPAC does not have an unconditional right to avoid delivering cash or another financial asset. The SPAC Shares will hence give rise to a financial liability component until the redemption feature lapses (usually at the time of the De-SPAC Transaction).
- Any interest return obligations will also affect the measurement of the financial liability component.
- It is critical to fully understand the terms and voting mechanisms of the SPAC, in particular whether the shareholders' participation in key decision-making processes of the SPAC should be considered "an action of the SPAC" or "a private action of the shareholders and distinct from the entity".[4]
- The classification of the SPAC Shares may have to be reassessed when the redemption feature lapses. See *section 4 Following the De-SPAC Transaction*.

[4] In October 2021, the European Securities and Markets Authority submitted an Agenda Item Request to the IFRS Interpretations Committee for clarification on this very issue and whether the duty to present a De-SPAC Target for approval by the shareholders is a contractual obligation of the SPAC or merely an economic compulsion. These two questions will affect whether the SPAC Shares should be classified as equity or liability. The HKICPA will monitor the development of the discussion and provide updates as appropriate.

## Warrants

### Commonly seen features

- SPAC Warrants and SPAC Shares are separate instruments that are often issued together as a package at the time of the IPO. Promoter Warrants may be issued separately to the promoters.
- Warrants give their holders the right to purchase SPAC Shares at a pre-determined price.
- The Warrants could be settled gross, net in cash or shares or in a combination of different ways.

### Accounting considerations

- Similar to Promoter Shares, it is necessary to consider whether Promoter Warrants issued to promoters are within the scope of HKFRS 2 or HKAS 32. See related discussions above.
- Warrants generally include features that violate the “fixed-for-fixed” criterion in HKAS 32 resulting in their being classified as financial liabilities. Such features include:
  - ➢ variability in either the number of shares to be delivered or cash to be received (including a fixed amount of cash in a foreign currency), apart from adjustments that are purely anti-dilutive;
  - ➢ the underlying shares are classified at least in part as liabilities during the period when the Warrants may be exercised;
  - ➢ the underlying shares are *presented* as equity due solely to the application of HKAS 32.16A to 16D;
  - ➢ settlement options that do not all result in equity classification; and
  - ➢ net cash/ shares settlement features.
- The Warrants will be classified as equity if (i) the underlying SPAC Shares will be classified as equity and (ii) they can only be settled gross by the delivery of a fixed number of shares in exchange for a fixed amount of cash in the SPAC’s functional currency.

The fair value measurement of the various instruments and/or components therein may be complex and the involvement of valuation experts may be required.

Given the Promoter Shares, SPAC Shares and Warrants of different SPACs are subject to different jurisdictional features as well as terms and conditions, it is imperative for SPAC management to understand the listing rules of the relevant stock exchanges (Chapter 18B of the Listing Rules in the Hong Kong context), the provisions of the SPAC's own constitutional documents, shareholders' agreements as well as other relevant laws and regulations thoroughly when determining the appropriate accounting treatment for these instruments. Any significant judgements made should be disclosed in accordance with paragraph 122 of HKAS 1 *Presentation of Financial Statements*.

# 3. The De-SPAC Transaction

As the sole purpose of the SPAC after its IPO is to look for a De-SPAC Target, the De-SPAC Transaction is a significant event in the lifecycle of a SPAC. The accounting issues that come with it are of equal significance.

### *3.1 Identifying the accounting acquirer and determining whether it is a business combination*

Once the promoters and management team have finalised negotiations with a De-SPAC Target and the shareholders have approved the acquisition, the SPAC would acquire the De-SPAC Target resulting in a listed Successor Company. The key questions at this stage are (i) which entity is the accounting acquirer and (ii) is the transaction a business combination or an asset acquisition?

The **accounting acquirer** is the entity that obtains control of another entity and could be different from the legal acquirer. HKFRS 10 *Consolidated Financial Statements* contains guidance on which entity has control over another entity and this should be used to identify the accounting acquirer. If applying the guidance in HKFRS 10 does not provide a clear answer, the entity should consider the factors in paragraphs B14 to B18 of HKFRS 3 *Business Combinations* in making the assessment.

As regards whether the transaction is a **business combination or an asset acquisition**, HKFRS 3.B5 to B12D provide relevant guidance. If the assets acquired do not constitute a business, the transaction is accounted for as an asset acquisition and the accounting acquirer should identify and recognise the individual identifiable assets acquired and liabilities assumed in accordance with HKFRS 3.2(b). On the other hand, if the De-SPAC Transaction is a business combination, the transaction is within the scope of HKFRS 3.

The table below summarises a few of the accounting permutations for a De-SPAC Transaction:

| Accounting acquirer | Asset acquistion | Business combination |
|---|---|---|
| **De-SPAC Target** | Scenario 1 | Scenario 3 |
| **SPAC** | Scenario 2 | Scenario 4 |

Each of the scenarios is discussed further below.

***Scenario 1: De-SPAC Target is the accounting acquirer in an asset acquisition***

This is a common scenario.

The merger of the De-SPAC Target into a non-operating listed cash shell typically results in the shareholders of the De-SPAC Target obtaining control over the Successor Company after the acquisition. The purpose of the transaction is for the De-SPAC Target to obtain a listing on a stock exchange. Furthermore, the SPAC's being a cash shell with limited activities is unlikely to meet the definition of a business in terms of HKFRS 3. As such, it is common for the De-SPAC Target to be identified as the accounting acquirer of a set of assets in the De-SPAC Transaction.

The transaction is not a reverse acquisition as the SPAC is not a business as defined. Instead, the transaction could be described as a capital reorganisation or a reverse asset acquisition.

The IFRS Interpretations Committee (IFRS IC) issued an Agenda Decision in March 2013 in which it considered a similar scenario. The Agenda Decision confirmed that if the listed entity (SPAC) is not a business, the transaction is not a business combination but rather a share-based payment transaction under IFRS 2[5]. In this case, the De-SPAC Target is deemed to have issued its own shares to the SPAC shareholders to obtain control over the SPAC and to acquire a listing on a stock exchange.

Applying HKFRS 2, any excess of the **fair value of the shares** deemed to have been issued by the De-SPAC Target over the **fair value of the SPAC's identifiable net assets** represents a listing service received by the De-SPAC Target. The Agenda Decision further confirms that regardless of the level of monetary or non-monetary assets owned by the non-listed operating entity (De-SPAC Target), the entire difference between the two fair values should be considered to be a payment for obtaining a listing and no amount should be considered to be a cost of raising capital.

[5] HKFRS/HKAS are converged with IFRS/IAS.

The payment for obtaining a listing cannot be capitalised because it is neither "identifiable" in accordance with paragraph 12 of HKAS 38 *Intangible Assets* nor does it meet the definition of an asset that should be recognised in accordance with other HKFRS or the Conceptual Framework. As such, the cost should be expensed as incurred in accordance with HKFRS 2.8.

Refer to Illustration 1 below for a numerical example.

The resulting consolidated financial statements of the Successor Company is similar to a reverse acquisition under HKFRS 3:

- they are prepared in the name of the legal acquirer (SPAC) but reflect a continuation of the legal acquiree's (De-SPAC Target's) financial information with an adjustment to the De-SPAC Target's legal capital to reflect that of the SPAC upon the De-SPAC Transaction.
- the pre-combination financial information (including comparatives) includes only that of the De-SPAC Target.
- the SPAC's financial information is included in the consolidated financial statements prospectively from the date of acquisition.
- the pre-combination equity structure of the De-SPAC Target may, by analogy to HKFRS 3's requirement on reverse acquisitions, be restated using the exchange ratio established in the acquisition agreement to reflect the number of shares issued by the SPAC in the transaction.
- the cash of the SPAC acquired by the De-SPAC Target through the De-SPAC Transaction is expected to be presented within financing activities as it relates to a change in the size and composition of the contributed equity of the Successor Company.
- **however, as the transaction is not a business combination**, no goodwill is recognised. Deferred tax would also not be recognised on any temporary difference arising from the initial recognition of assets or liabilities at the time of the De-SPAC Transaction unless (i) they affect either accounting or taxable profit at the time of the transaction or (ii) they give rise to equal taxable and deductible temporary differences at the time of the transaction.

### *Illustration 1 - De-SPAC Target is the accounting acquirer in an asset acquisition*

**Background**

SpaceCo is a listed SPAC that is not a business as defined. It is actively searching for an acquisition target in the technology field. TargetCo is an unlisted operating company that focuses on the development of high-tech products such as AI drones. To acquire TargetCo, SpaceCo issues new shares to the shareholders of TargetCo in exchange for all their shares in TargetCo. After the transaction, the original shareholders of TargetCo own 80% of the merged entity, and the remaining 20% is held by the original SpaceCo shareholders.

Pertinent information immediately before the acquisition is as follows:

<u>SpaceCo</u>

- Share price: $12.5/share
- Fair value and book value of identifiable net assets (cash only)*: $100million
- 10 million shares in issue

<u>TargetCo</u>

- Fair value of shares: $500 million
- 1.6 million shares in issue

**Analysis**

Although the legal acquirer is SpaceCo, the accounting acquirer is the entity that obtains control of another entity which may not always be the legal acquirer. The guidance in HKFRS 10 and the factors in HKFRS 3.B14 to B18 should be considered to identify the accounting acquirer.

The substance of this transaction is that TargetCo has acquired SpaceCo for its listing status. TargetCo is the accounting acquirer and as SpaceCo is not a business as defined, the transaction falls outside the scope of HKFRS 3 and is accounted for in accordance with HKFRS 2 as a share-based payment from TargetCo's perspective.

* *There are no warrants in this example and assume there are no liabilities associated with the Promoter Shares or SPAC Shares.*

TargetCo is deemed to have issued its own shares to acquire control of SpaceCo. In order for the original shareholders of TargetCo to retain 80% interest in the merged entity, TargetCo would need to issue 400,000 shares (1.6m / 80% x 20%) to SpaceCo shareholders. The original TargetCo shareholders would then hold 80% in the merged entity (1.6m / 2m) and the original SpaceCo shareholders would hold 20% in the merged entity (0.4m / 2m).

The total fair value of shares deemed to have been issued by TargetCo to acquire SpaceCo is therefore: ($500m / 1.6m shares x 400,000 shares) = $125 million. This is the consideration transferred for the reverse asset acquisition.

Based on the guidance in HKFRS 2.13A, any difference between the fair value of the shares deemed to have been issued by TargetCo ($125m) and the fair value of SpaceCo's identifiable net assets ($100m) represents a listing service received by TargetCo ($125m - $100m = $25m).

The payment of $25 million for obtaining a listing cannot be capitalised because it is neither "identifiable" in accordance with HKAS 38.12 nor does it meet the definition of an asset that should be recognised in accordance with other HKFRS or the Conceptual Framework. As such, the cost should be expensed as incurred (i.e. on the date of the reverse asset acquisition) in accordance with HKFRS 2.8.

The following journal entry should be processed for the transaction in the consolidated financial statements of the Successor Company:

| | | | |
|---|---|---|---|
| Dr. | Cash (from SpaceCo) | $100 million | |
| Dr. | Listing expense (profit or loss) | $25 million | |
| Cr. | Equity (deemed issue by TargetCo) | | $125 million |

The SPAC typically has outstanding Warrants at the time of the De-SPAC Transaction. Although the 2013 IFRIC Agenda Decision does not address such a case, the Warrants should generally be taken into account when determining the listing expense. This could be done either through an adjustment to the consideration transferred or including the Warrants in the net assets acquired especially if they are classified as liabilities by the SPAC. *The resulting listing expense will be the same either way*.

Care should be taken that the adjustment is made only once to ensure no double-counting. See illustration 2.

*Illustration 2 – Treatment of outstanding warrants at the time of the reverse asset acquisition*

**Background**

Same fact pattern as in illustration 1, except that SpaceCo has outstanding warrants at the time of the De-SPAC Transaction. The warrants are classified as liabilities in SpaceCo's financial statements with a fair value of $10 million. The fair value and book value of the identifiable net assets of SpaceCo is thus $90 million ($100m cash less $10m warrant liabilities).

**Analysis**

TargetCo could account for the fair value of the warrants as part of the consideration transferred, i.e. $135 million comprising $125m (fair value of equity deemed to have been issued by TargetCo) and $10m (fair value of the warrant liabilities). Since an adjustment has been made to the consideration transferred, the net assets acquired would be just the cash of $100m, resulting in a listing expense of $35m ($135m - $100m).

Alternatively, the warrant liability could be accounted for as part of the net assets acquired ($90m) and no adjustment is made to the consideration transferred ($125m). The resulting listing expense is also $35m ($135m - $100m) in this case.

Either way, the following journal entry should be processed for the transaction in the consolidated financial statements of TargetCo:

| | | | |
|---|---|---|---|
| Dr. | Cash (from SpaceCo) | $100 million | |
| Dr. | Listing expense (profit or loss) | $35 million | |
| Cr. | Warrant (liability) | | $10 million |
| Cr. | Equity (deemed issue by TargetCo) | | $125 million |

***Scenario 2: SPAC is the accounting acquirer in an asset acquisition***

This scenario is unlikely under the HK SPAC regime because according to LR18B.36 the Successor Company has to comply with all the relevant listing requirements. Given the SPAC is a shell company, if the De-SPAC Target is not a business as defined then LR18B.36 is unlikely to be met.

If in the unlikely event that this scenario applies, the transaction will be accounted for by the SPAC just like any other asset acquisitions. In other words:

- the De-SPAC Target's assets and liabilities are included in the Successor Company's financial statements prospectively from the date of acquisition.
- The pre-combination financial information (including comparatives) of the Successor Company includes only that of the SPAC.
- The cost of the asset acquisition is allocated to the individual identifiable assets and liabilities of the De-SPAC Target based on their relative fair values at the date of acquisition.
- No goodwill is recognised.
- Deferred tax would also not be recognised on any temporary difference arising from the initial recognition of assets or liabilities at the time of the De-SPAC Transaction unless (i) they affect either accounting or taxable profit at the time of the transaction or (ii) they give rise to equal taxable and deductible temporary differences at the time of the transaction.

***Scenario 3: De-SPAC Target is the accounting acquirer in a business combination***

This scenario is expected to be rare given the SPAC has limited operations and its assets consist largely of cash. The SPAC is thus unlikely to meet the definition of a business.

If in the unlikely event that the SPAC does indeed meet the definition of a business, the transaction will be accounted for as a reverse acquisition and all the recognition and measurement requirements in HKFRS 3 apply, including the recognition of goodwill.

The Successor Company also needs to comply with the guidance in HKFRS 3.B19 to B27. For example, the consolidated financial statements of the Successor Company will be prepared under the name of the legal parent (i.e. SPAC) but will reflect a continuation of the financial statements of the legal subsidiary (De-SPAC Target), with an adjustment to the De-SPAC Target's legal capital to reflect that of the SPAC.

***Scenario 4: SPAC is the accounting acquirer in a business combination***

This will be accounted for similarly to a typical business combination. The HKFRS 3 recognition and measurement requirements apply in full:

- The SPAC would recognise the De-SPAC Target's identifiable assets and liabilities at fair value (subject to exceptions in HKFRS 3) on the acquisition date.
- Any resulting goodwill would be recognised and be subject to annual impairment reviews.
- Acquisition-related costs are expensed as incurred unless they are directly attributable to the issue of equity or debt instruments.
- The pre-combination financial information (including comparatives) include only that of the SPAC.

### *3.2 Private investment in public equity (PIPE) investment*

A PIPE investment is a private issue of SPAC Shares to professional, sophisticated and/or institutional investors, the completion of which is contingent upon the closing of the De-SPAC Transaction. The proceeds from the PIPE investment are often used to compensate for any share redemptions prior to the De-SPAC Transaction, to fund the De-SPAC Transaction itself or for future operations of the Successor Company. The Listing Rules mandate minimum independent PIPE investments to complete a De-SPAC Transaction to mitigate the risk of artificial valuations of the De-SPAC Target.

SPAC management needs to consider how to account for such a contract to issue SPAC Shares and how the PIPE investment should be incorporated into the calculation of the listing expense in a reverse asset acquisition scenario.

### *3.3 Earn-out arrangements and contingent share-based payments*

De-SPAC Transactions often involve earn-out arrangements or other contingent share-based payments whereby additional shares will be issued to the original shareholders of the SPAC, those of the De-SPAC Target, employees of either company or a combination of these individuals if certain targets are met. These arrangements may be entered into for various reasons, e.g. uncertainties over the valuation of the De-SPAC Target (such that more shares will be issued to the original shareholders of the De-SPAC Target if the Successor Company's performance exceeds expectation) or to retain the services of key employees.

It is therefore important to assess whether such earn-out or share-based payment arrangements are part of the combination transaction or whether they relate to separate transactions such as remuneration for post-combination services. This assessment requires a thorough analysis of the facts and circumstances specific to each case and may involve significant judgement. HKFRS 3.B54 to B55 provide relevant guidance in this regard (and by analogy to asset acquisitions).

If the arrangement is part of the combination transaction, it will affect the fair value of the consideration transferred for the De-SPAC Transaction and hence the resulting amount of listing expense (in the case of the De-SPAC Target's being the accounting acquirer in an asset acquisition) or goodwill (if it is a business combination). In contrast, if the arrangement relates to a separate transaction such as remuneration for post-combination services, it will not affect the fair value of the consideration transferred. Instead, the fair value of the share awards is expensed over the vesting period unless it meets the criteria for capitalisation in accordance with another HKFRS.

How such arrangements are accounted for also depends on whether the SPAC or the De-SPAC Target is the accounting acquirer and whether the De-SPAC Transaction is a business combination. Given the more common scenario of the De-SPAC Target's being the accounting acquirer in an asset acquisition, the table below outlines a few typical earn-out and share-based payment arrangements and their respective accounting considerations in this context.

## Accounting considerations for typical earn-out and share-based payment arrangements (assuming De-SPAC Target is the accounting acquirer in an asset acquisition)

EXAMPLE 1

The De-SPAC Transaction includes a performance earn-out scheme under which additional shares are issued to the original shareholders of the SPAC and/or De-SPAC Target, and/or certain key employees upon the occurrence of certain events (e.g. the share price of the Successor Company exceeding a target value). No service condition is attached.

**Accounting considerations**

It is necessary to determine whether the earn-out arrangement is part of the reverse asset acquisition (i.e. contingent consideration for the De-SPAC Transaction) or a separate post-combination remuneration transaction (i.e. payment for future services). HKFRS 3.B54 to B55 provide relevant guidance by analogy in this regard.

If the earn-out arrangement is part of the reverse asset acquisition, since there is no service condition,[6] the performance targets are treated as non-vesting conditions. Non-vesting conditions are taken into account when estimating the fair value of equity-settled share-based payments at grant date. As such, the probability of meeting the earn-out targets is taken into account when determining the grant date fair value of the share awards.[7] This fair value adjusts the consideration transferred for the reverse asset acquisition which in turn affects the amount of listing expense recognised.[8]

The consideration transferred is not subsequently adjusted regardless of whether or the extent to which the non-vesting conditions are met.

6 See HKFRS 2 for the definitions of vesting condition, service condition and performance condition.

7 More specifically, the probability of meeting the earn-out targets is taken into account when estimating the total number of shares that the De-SPAC Target is deemed to have issued for obtaining control over the SPAC. This in turn affects the total fair value of the consideration transferred. See illustration 1 in section 3.1 for a numerical example.

8 This is consistent with HKFRS 2.21A which requires an entity to recognise the goods or services received (the listing service in this example) that satisfies all non-market vesting conditions (of which there is none in this example), irrespective of whether the non-vesting conditions are satisfied.

SPAC management must continue to work for the Successor Company for three years in order to earn share-based payment awards granted before the De-SPAC Transaction. The awards are automatically forfeited if the grantees leave within three years of the De-SPAC Transaction.

EXAMPLE 2

**Accounting considerations**

The share-based payment is remuneration for post-combination services and should be accounted for under HKFRS 2.[9]

As the De-SPAC Target is the accounting acquirer, the consolidated financial statements of the Successor Company will not include any previous accounting for these share awards. As a result, a new grant date fair value for these awards will need to be determined.

Equity-settled share-based payments granted to employees of the De-SPAC Target before the De-SPAC Transaction are modified, exchanged for the Successor Company's shares, settled for cash or cancelled.

EXAMPLE 3

**Accounting considerations**

The modifications to, settlements or cancellations of existing equity-settled share-based payments of the De-SPAC Target will need to be accounted for under HKFRS 2.26-29.

[9] HKFRS 3.B55(a) as confirmed by the IFRIC January 2013 agenda decision *IFRS 2* Share-based Payment—*Definition of 'vesting conditions'*.

### *3.4 Transaction costs*

As with all traditional IPOs, management needs to take due care in assessing which costs associated with the De-SPAC Transaction are incremental costs directly attributable to the issue of equity instruments (i.e. transaction costs as defined in HKFRS 9) in which case the costs will be recognised as a deduction from equity; versus costs relating to *listing the entity's existing* equity instruments, which are not transaction costs as defined and will be expensed as incurred.

This assessment is particularly important as in many De-SPAC Transactions accounted for as a reverse asset acquisition (see Scenario 1 in section 3.1), the De-SPAC Target is deemed to be concurrently issuing new shares for cash and obtaining a listing for its existing shares. Transaction costs that relate jointly to more than one transaction need to be allocated to those transactions on a rational basis consistently with similar transactions.

To sum up, this section outlined certain key accounting considerations at the time of the De-SPAC Transaction. As with the classification of Promoter Shares, SPAC Shares and Warrants in section 2, management should consider all relevant facts and circumstances specific to its case to determine which entity is the accounting acquirer and whether the transaction is a business combination as defined. The same goes for share-based payment and other arrangements that are entered into at the time of the De-SPAC Transaction.

# 4. Following the De-SPAC Transaction

## *4.1 Reassessing the classification of Shares and Warrants*

Following the De-SPAC Transaction, all shares will generally become 'plain vanilla' shares as the Promoter Shares will have mandatorily converted into SPAC Shares and the SPAC Shares will no longer be redeemable.

Management should assess whether it is appropriate to reconsider whether the Shares and Warrants are within the scope of HKFRS 2 or HKAS 32 (with the ensuing equity v. liability consideration) following the De-SPAC Transaction.

If the Shares and Warrants continue to be within the scope of HKAS 32 and there is a change in the effective terms of the instruments (e.g. a lapse of the redemption right of the SPAC Shares), it is unclear whether the Successor Company should or could reclassify the Shares and/or Warrants since their contractual terms have not changed. This was discussed in the October 2021 IFRIC agenda decision on *IAS 32 Financial Instruments: Presentation Accounting for Warrants that are Classified as Financial Liabilities on Initial Recognition*. The IFRS IC observed that IAS 32 contains no general requirements in this regard and that the IASB will consider addressing this issue in its Financial Instruments with Characteristics of Equity project.

All in all, it is imperative that management makes an assessment based on the Warrants' (and the Promoter / SPAC Shares') specific terms and conditions taking into account all relevant facts and circumstances. Any significant judgement applied in the process should be disclosed in accordance with HKAS 1.122.

## *4.2 Earnings per share and operating segments*

Certain HKFRS are generally applicable to listed entities only, such as HKFRS 8 *Operating Segments* and HKAS 33 *Earnings per Share* ("EPS"). The Successor Company needs to consider the financial reporting implications of applying these standards for the first time after the De-SPAC Transaction. For example, if the De-SPAC Target is identified as the accounting acquirer, the following may be relevant:

- Management may need to spend extra time and costs to gather and verify the historical financial information of the De-SPAC Target for the purposes of compiling operating segment disclosures and EPS calculations for the pre-combination period (including comparatives).[10]

- The calculation of EPS will need careful consideration. Any event that changes the number of shares of the Successor Company without a corresponding change in resources must be adjusted retrospectively, i.e. restating the comparative period's EPS. In terms of current year EPS, the weighted average number of ordinary shares outstanding for the Successor Company is calculated as follows (assuming the De-SPAC Target is the accounting acquirer)

| | **Weighted average ("WA") no. of ordinary shares outstanding** | |
|---|---|---|
| | From beginning of period to acquisition date | From acquisition date to end of period |
| **Computation method** | WA no. of outstanding shares of De-SPAC Target multiplied by the exchange ratio established in the reverse asset acquisition agreement | Actual no. of outstanding shares of the Successor Company |

- In addition, any outstanding financial instruments issued by the Successor Company that might entitle their holder to ordinary shares in the future must be assessed for dilutive EPS purposes (e.g. Warrants issued as part of the SPAC's IPO, shares that may be issuable under earn-out arrangements, equity-settled share-based payments, etc.).

- For equity-settled share-based payments within the scope of HKFRS 2, any unvested portion of the grant date fair value of the equity instruments should be included in the exercise price referred to in HKFRS 2.47 when calculating their dilutive impact.

- Since it is likely that the Successor Company will have different types of outstanding potential ordinary shares issued at different times, management needs to assess *each issue/series* of potential ordinary shares *separately* in determining whether *each issue/series* is dilutive or antidilutive. Each issue/series is considered in sequence from the most dilutive to the least dilutive in accordance with HKAS 33.44 for this purpose.:

[10] The listing document for the De-SPAC Transaction prepared under the Listing Rules may already include operating segment disclosures and EPS calculations of the De-SPAC Target for the pre-combination period via the Accountants' Report.

### *4.3 Other considerations*

Following the acquisition of the De-SPAC Target, the Successor Company becomes a listed entity carrying on the business of the De-SPAC Target. As a listed entity it must comply with all the relevant regulatory requirements that come with this role.

In the Hong Kong context, the Companies Ordinance (Cap. 622), the Listing Rules and the Financial Reporting Council, *inter alia*, stipulate additional requirements for listed entities. At a minimum this includes having appropriate policies, processes and internal controls in place to perform as a public entity as well as providing management commentary, corporate governance reports and ESG reports amongst others to accompany the financial statements.

Management of the Successor Company should take note of these additional reporting requirements and other responsibilities as a listed issuer. Given the timeline to becoming a listed entity under the SPAC regime is typically shorter than that of a traditional IPO, management needs to allow themselves sufficient time to prepare for all the additional duties that come with being a public entity which is subject to public scrutiny.

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*The SSD welcomes your comments on this publication. They can be sent to commentletters@hkicpa.org.hk.*

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