

# SPOTLIGHT

## Inspection Observations – Audits of Special Purpose Acquisition Companies and De-SPAC Transactions

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April 2023

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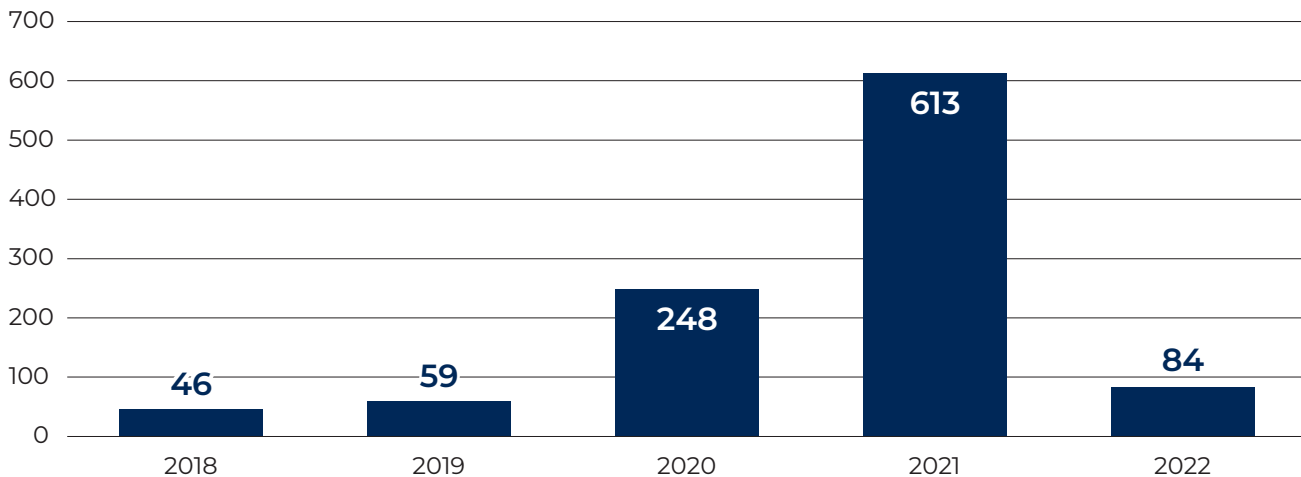
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## OVERVIEW

From 2020 to 2021, the U.S. markets experienced an unprecedented surge in the number of initial public offerings (IPOs) by special purpose acquisition companies (SPACs). SPACs typically have no commercial operations and are public companies formed solely to raise capital to merge with or acquire a private company, effectively taking it public.

A rush to raise capital during the COVID-19 pandemic created a boom in the U.S. SPAC market, although the investment vehicle has been around for decades. In 2020, the U.S. SPAC market tallied 248 IPOs and gross proceeds of \$75.3 billion. In 2021, those figures grew to 613 IPOs and gross proceeds of \$144.5 billion. While SPAC activity dropped in 2022, to 84 IPOs, that number represented more SPAC IPOs than occurred each year in the decade prior to 2020.

### Number of SPAC IPOs



In 2021, the staff of the Securities and Exchange Commission (SEC) issued public statements during a rise in the popularity of SPACs.<sup>1</sup> The SEC staff have noted that the market interest ebbs and flows, with certain market participants having a view that a SPAC transaction is a way to take a private company public with more certainty as to pricing and control over deal terms as compared to traditional IPO; and other market participants may also view the SPAC process as simpler and faster than a traditional IPO. Because companies going public via SPACs are not subject to many of the conventions and requirements of a traditional IPO – including reporting requirements – and because of their structure, SPACs pose risks to investors not present in traditional IPOs.

The Division of Registration and Inspections (“we”) considered these risks to investors as we planned our inspections over the last two years. We reviewed more than 100 audits of companies that were either considered SPACs or were formed through a de-SPAC transaction. Many of these companies classified warrants<sup>2</sup> issued during the IPO of the SPAC with certain features as equity

<sup>1</sup> See the SEC’s statement “SPACs, IPOs and Liability Risk under the Securities Laws” (April 8, 2021) and Updated Investor Bulletin, “What You Need to Know About SPACs” (May 25, 2021).

<sup>2</sup> See the SEC’s “Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (“SPACs”)” (April 12, 2021).

and subsequently restated their financial statements to classify these warrants as a liability. We observed instances where the public company’s auditors failed to identify material misstatements in issued financial statements due to errors in the accounting for warrants. This Spotlight provides investors and other stakeholders a view into our inspection observations related to SPAC and de-SPAC transactions at the height of this activity and offers valuable insights should interest in these transactions surge in the future.

## INSPECTION OBSERVATIONS

Our reviews of audits of SPACs and de-SPAC transactions most frequently focused on the following audit areas: (1) assessing the valuation of financial instruments using complex valuation models, (2) evaluating quarterly mark-to-market valuation adjustments, (3) determining which entity in a business combination is the accounting acquirer, (4) internal control over financial reporting (ICFR), if applicable, (5) evaluation of financial presentation and disclosures, and (6) restatements, if they occurred. We selected these areas because they were generally significant to the public company’s financial

### Key Terms

#### IPO

IPO refers to the process through which a private company offers shares to the public in a new stock issuance for the first time.

#### De-SPAC

A de-SPAC transaction refers to the merger of a public SPAC with a non-public operating company.

#### Warrants

A warrant is a contract that gives the holder the right to purchase from the company a certain number of additional shares of common stock in the future at a certain price, often at a premium to the stock price at the time the warrant is issued.

statements, may have included complex issues for auditors, and/or involved complex judgments. We observed the following in our inspections:

### Number of SPAC and De-SPAC Audit Engagements Inspected

|         | 2021 Audit Engagements Reviewed | Audits Included in Part I.A <sup>3</sup> | Part I.A Deficiency Rate |
|---------|---------------------------------|--|--------------------------|
| SPAC    | 16                              | 15                                       | 94%                      |
| De-SPAC | 28                              | 12                                       | 43%                      |
| Total   | 44                              | 27                                       |                          |

<sup>3</sup> Part I.A of the individual audit firm’s inspection report discusses deficiencies, if any, that were of such significance that we believe the audit firm, at the time it issued its audit report(s), had not obtained sufficient appropriate audit evidence to support its opinion on the public company’s financial statements and/or internal control over financial reporting.

|              | 2022 Audit Engagements Reviewed | Audits Expected To Be in Part I.A | Expected Part I.A Deficiency Rate |
|--------------|---------------------------------|-----------------------------------|-----------------------------------|
| SPAC         | 21                              | 7                                 | 33%                               |
| De-SPAC      | 50                              | 19                                | 38%                               |
| <b>Total</b> | <b>71</b>                       | <b>26</b>                         |                                   |

## Financial Statement Auditing Deficiencies

The auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

### Presentation of Financial Statements

We have observed audits of the public company's year-end financial statements where engagement teams did not:

- Identify and appropriately evaluate a generally accepted accounting principles (GAAP) departure related to:
  - o Warrants prior to the restatement of the public company's financial statements, stock compensation, and/or measurement and classification of redeemable shares;
  - o The omission of certain required fair value measurement disclosures in the public company's financial statements; or
- Identify the significance to the financial statements of the public company's error in the presentation and disclosure related to contract assets from contracts with customers.

### Auditor's Responsibility

In accordance with *AS 2810, Evaluating Audit Results*, the auditor must evaluate whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

As part of the evaluation of the presentation of the financial statements, the auditor should evaluate whether the financial statements contain the information essential for a fair presentation of the financial statements in conformity with the applicable financial reporting framework. Evaluation of the information disclosed in the financial statements includes consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items in the statements, and the bases of amounts set forth.

### Auditing Accounting Estimates, Including Fair Value Measurements

We have observed audits of the public company's year-end financial statements where engagement teams did not:

- Perform sufficient procedures to test the valuation of the warrant liabilities, including performing procedures to evaluate the reasonableness of certain significant assumptions used in the valuation.

- Evaluate potential bias affecting the volatility assumption used to estimate the fair value of the warrants at year-end.
- Evaluate the reasonableness of the significant assumptions, including taking into account the public company's ability to carry out a particular course of action.

### Auditor's Responsibility

In accordance with *AS 2501, Auditing Accounting Estimates, Including Fair Value Measurements*, the auditor should evaluate the reasonableness of the significant assumptions used by the company to develop the estimate, both individually and in combination. This includes evaluating whether:

- a. The company has a reasonable basis for the significant assumptions used and, when applicable, for its selection of assumptions from a range of potential assumptions; and
- b. The significant assumptions are consistent with the following, when applicable:
  1. Relevant industry, regulatory, and other external factors, including economic conditions;
  2. The company's objectives, strategies, and related business risks;
  3. Existing market information;
  4. Historical or recent experience, taking into account changes in conditions and events affecting the company; and
  5. Other significant assumptions used by the company in other estimates tested.

In addition, when a significant assumption is based on the company's intent and ability to carry out a particular course of action, the auditor should take into account the following factors in evaluating the reasonableness of the assumption:

- a. The company's past history of carrying out its stated intentions;
- b. The company's written plans or other relevant documentation, such as budgets or minutes;
- c. The company's stated reasons for choosing a particular course of action; and
- d. The company's ability to carry out a particular course of action, which includes consideration of whether:
  1. The company has the financial resources and other means to carry out the action;
  2. Legal, regulatory, or contractual restrictions could affect the company's ability to carry out the action; and
  3. The company's plans require the action of third parties and, if so, whether those parties are committed to those actions.

In addressing critical accounting estimates, the auditor should obtain an understanding of how management analyzed the sensitivity of its significant assumptions to change, based on other reasonably likely outcomes that would have a material effect on its financial condition or operating performance. The auditor should take that understanding into account when evaluating the reasonableness of the significant assumptions and potential management bias.

### Responding to Risks of Material Misstatement

We have observed audits of the public company's year-end financial statements where engagement teams did not perform sufficient substantive procedures, including tests of details.

## Auditor's Responsibility

In accordance with [AS 2301, \*The Auditor's Responses to the Risks of Material Misstatement\*](#), the auditor should design and implement overall responses to address the assessed risks of material misstatement. Among other things, that means that the auditor should evaluate whether the public company's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions, are indicative of bias that could lead to material misstatement of the financial statements.

In addition, the auditor should perform substantive procedures for each relevant assertion of each significant account and disclosure, regardless of the assessed level of control risk. Performing substantive procedures for the relevant assertions of significant accounts and disclosures involves testing whether the significant accounts and disclosures are in conformity with the applicable financial reporting framework.

In addressing fraud risks in the audit of financial statements, the auditor should perform substantive procedures, including tests of details, that are specifically responsive to the assessed fraud risks.

## Audit Sampling

We have observed audits of the public company's year-end financial statements where engagement teams did not take into account the relevant factors, including tolerable misstatement of the population, the allowable risk of incorrect acceptance, and the characteristics of the population when determining the number of items to selected in a sample for particular substantive test of details.

## Auditor's Responsibility

In accordance with [AS 2315, \*Audit Sampling\*](#), to determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should take into account tolerable misstatement for the population; the allowable risk of incorrect acceptance (based on the assessments of inherent risk, control risk, and the detection risk related to the substantive analytical procedures or other relevant substantive tests); and the characteristics of the population, including the expected size and frequency of misstatements.

## Audit Evidence

We have observed audits of the public company's year-end financial statements where engagement teams did not perform procedures to test, or in the alternative, test controls over, the accuracy and completeness of the data produced by the company used in its substantive testing.

## Auditor's Responsibility

In accordance with [AS 1105, \*Audit Evidence\*](#), when using information produced by the company as audit evidence, the auditor should evaluate whether the information is sufficient and appropriate for purposes of the audit by performing procedures to:

- Test the accuracy and completeness of the information, or test the controls over the accuracy and completeness of that information; and
- Evaluate whether the information is sufficiently precise and detailed for purposes of the audit.

## ICFR Auditing Deficiencies

We observed audits of the public company's year-end financial statements, where material

weaknesses in ICFR were pervasive due to company management's lack of experience. We observed examples where auditors did not:

- Evaluate procedures that the control owners performed over controls with a review element to assess the reasonableness of the prospective financial information assumptions used in the valuation of contingent consideration and acquired intangible assets, including the procedures to identify items for follow up and the procedures to determine whether those were appropriately resolved.
- Evaluate the review procedures that the control owners performed to assess whether the consideration transferred was appropriate and excluded items that were required to be accounted for as separate transactions.

### Auditor's Responsibility

In accordance with *AS 2201, An Audit of Internal Controls Over Financial Reporting That Is Integrated with the Audit of Financial Statements*, the risk associated with a control consists of the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases. Factors that affect the risk associated with a control include (but are not limited to) the competence of the personnel who perform the control or monitor its performance.

As noted in *Staff Audit Practice Audit Alert No. 11, Considerations for Audits of Internal Controls*, testing the operating effectiveness of a management review control involves performing procedures to evaluate whether the control is working as designed to prevent or detect potentially material misstatements. Testing typically involves, for selected

operations of the control, obtaining and evaluating evidence about:

- a. The steps performed to identify and investigate significant differences; and
- b. The conclusions reached in the reviewer's investigation, including whether potential misstatements were appropriately investigated and whether corrective actions were taken as needed.

The nature, timing, and extent of testing should be commensurate with the risk associated with the controls. Higher risk controls warrant more testing.

The auditor also should take into account other relevant evidence obtained in the audit when evaluating the effectiveness of a control, such as identified misstatements that were not prevented or detected by the control.

### Other Instances of Noncompliance With PCAOB Standards or Rules

In our inspections, we assess an audit firm's compliance with specific PCAOB standards and/or rules.

### Audit Documentation

We observed instances where engagement teams did not assemble a complete and final set of audit documentation for retention within 45 days following the report release dates.

### Auditor's Responsibility

As it states in *AS 1215, Audit Documentation*, prior to the report release date, the auditor must have completed all necessary auditing procedures. In addition, the auditor must have obtained sufficient evidence to support the representations in the auditor's reports before the report release date. After the report



release date and prior to the documentation completion date, the auditor has 45 calendar days in which to assemble the documentation.

## Communications With Audit Committees

We observed instances where engagement teams did not:

- Make communications, in writing, to the audit committee that a material weakness was identified during the audit.
- Make required communications to the public company's audit committee, as the engagement team did not communicate to the audit committee its assessment of critical accounting policies and practices and its conclusions regarding critical accounting estimates that were disclosed in the public company's required reporting, such as:
  - o Accounting for the acquisition as a reverse acquisition, or
  - o The useful lives of assets and inputs used to calculate the tax receivable agreement liability.
- Establish an understanding of the terms of the audit engagement with the audit committee, record such understanding in an engagement letter, and provide the engagement letter to the audit committee.

### Auditor's Responsibility

In accordance with *AS 2201: An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, the auditor must communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting.

Additionally, *AS 1301, Communications with Audit Committees*, states that the auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses.

## Supervision of the Audit Engagement

We observed instances where engagement teams did not evaluate the work of the auditor-employed specialist.

### Auditor's Responsibility

In accordance with *AS 1201, Supervision of the Audit Engagement*, the engagement partner is responsible for proper supervision of the work of engagement team members and for compliance with PCAOB standards, including standards regarding using the work of specialists, other auditors, internal auditors, and others who are involved in testing controls.

## Independence

We have also observed instances where the audit firm did not:

- Appear to be independent of the public company, including members of the engagement team having other financial interest in an audit client through an online, uninsured account, and thereby creating prohibited financial relationships.
- Appear to have been independent of the public company as the audit firm did not obtain pre-approval from the public company's audit committee for the audit services before the engagement.

## Auditor's Responsibility

As required by PCAOB Rule 3520, *Auditor Independence*, a registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

## Quality Control

We observed instances where the audit firms did not gain a timely understanding of emerging financial reporting and auditing risks related to SPAC and de-SPAC transactions. The audit firms' quality control systems did not provide reasonable assurance that the audit firms:

- Only undertook engagements that it could reasonably expect to complete with professional competence,
- Appropriately considered the risks associated with providing professional services in the particular circumstances,
- Assigned work on those engagements to persons who had the technical training and proficiency required in the circumstances,
- Ensured that supervisory activities performed by the audit firm's engagement partners met the requirements, and
- Ensured that an engagement quality review (EQR) was performed with due care by the EQR partners.

## Auditor's Responsibility

In accordance with *QC 20, System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, policies and procedures should be established for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for that client.

Such policies and procedures should also provide reasonable assurance that the audit firm:

- Undertakes only those engagements that the firm can reasonably expect to be completed with professional competence.
- Appropriately considers the risks associated with providing professional services in the particular circumstances.

Additionally, policies and procedures should be established to provide the audit firm with reasonable assurance that the work performed by engagement personnel meets applicable professional standards, regulatory requirements, and the firm's standards of quality.

Further, policies and procedures for engagement performance encompass all phases of the design and execution of the engagement. To the extent appropriate and as required by applicable professional standards, these policies and procedures should cover planning, performing, supervising, reviewing, documenting, and communicating the results of each engagement. These policies and procedures also should address engagement quality reviews pursuant to *AS 1220, Engagement Quality Review*.

## KEY TAKEAWAYS FROM OUR INSPECTION OBSERVATIONS

It is important for auditors to keep in mind the following:

- Exercise due professional care and professional skepticism.
- Consider whether presentation and disclosures in the financial statements conform with GAAP.

- Communicate with the public company's audit committee about any significant changes to the fraud or other significant risks initially identified in the planned audit strategy and the reasons for such changes.
- Understand the public company's processes to develop its accounting estimates, including the methods, data, and assumptions used.
- Remain alert to changes in the public company's or the auditor's circumstances which may give rise to situations that could impair auditor independence.
- Consider the nature of the public company, the risks of material misstatement, and each audit engagement team member's knowledge, skill, and ability when assigning work to engagement team members and determining the necessary extent of supervision.
- Identify and assess the risks of material misstatement due to error or fraud throughout the audit. New challenges may arise, and auditors have a responsibility to adjust their audits to respond to new or evolving risks of material misstatement, including the competence of the personnel who perform the control or monitor its performance.

## Stay Tuned and in Touch

While the volatile financial markets and rising interest rates in 2022 made it less favorable for public companies to finance merger and acquisition activities (including de-SPAC transactions), we continued to see activity in certain industries and sectors, such as information technology. During 2023, we plan to evaluate the auditor's work on the following: (1) valuation and accounting of financial instruments using complex valuation models, (2) business combinations including reverse mergers, (3) ICFR, (4) financial statement presentation and disclosure, (5) significant equity or debt restructuring, and (6) the entity's ability to continue as a going concern. Any further observations will be shared in future Spotlight documents.

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