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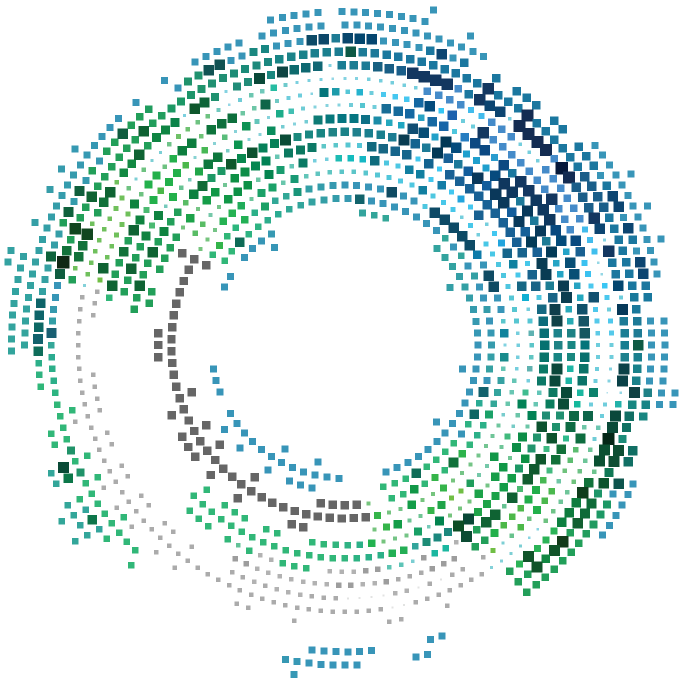

SPAC transactions in the digital asset ecosystem: Some preliminary considerations for emerging companies

During 2021, there was a notable increase in the activities of, and market interest in, special purpose acquisition company (SPAC) transactions with digital asset companies. SPAC mergers enable private operating companies (targets) to go public in a way that permits the target to negotiate pricing upfront, thereby offsetting the risk of market volatility and allowing companies to include forward-looking projections in their SEC filings. Many companies that engage in transactions with digital assets are finding that these benefits outweigh the advantages of a traditional IPO.

During 2021, Web3, based upon the blockchain and the foundation of the newly coined metaverse digital experience, began gaining traction as an alternative to the worldwide web.[1] Non-fungible tokens (NFTs) and digital assets recorded on the blockchain have become the latest asset class to garner significant investment from the investing community, including individual investors. And mainstream companies have begun to accept bitcoin, ethereum, and other digital assets as payment. This has created an expanding market for companies that operate in, and around, the digital asset market, including digital asset miners, trading exchanges, custodians, and content originators. This activity has, moreover, resulted in considerably increased interest from investors, and in particular SPACs, that are seeking new avenues into this industry.

In 2021, there were more than 600 SPAC IPOs that raised over $162 billion. According to SPAC Research, as of January 3, 2022, of those SPACs that describe themselves as searching for targets in the financial services industry, more than 50 have raised a total of $14.5 billion in IPO proceeds. In addition, there are over 20 that have announced deals with total enterprise value of $57.1 billion for the target companies. Further, specific to bitcoin and digital asset companies, there were at least 12 SPAC acquisitions announced or closed in 2021, with the lion's share in the second half of the year. Many involved the acquisition of a target company specifically within the digital asset ecosystem. The most common subsectors are in bitcoin mining and digital asset trading platforms. Of those 12 announced, according to SPAC Research, two SPACs closed deals that involved digital asset entities, each with a total enterprise value of $2.0 billion or greater.[2]

While digital asset target companies can be, and have been, acquired by SPACs from multiple industries, we believe that the financial services industry statistics can serve as a barometer of the potential SPAC proceeds available for acquiring digital asset target companies. Of those 12 mentioned above, 10 are within the fintech industry, with a total enterprise value of $28.5 billion. The remaining two are in the technology industry.[3]

Yet, the overall process of going public via a SPAC merger is, generally speaking, not easier than a traditional IPO given the demands of technical accounting, disclosure requirements, Security and Exchange Commission (SEC) regulations, and structuring considerations, as well as the internal controls implications. The fact is the target company must devote substantial time and resources to these matters, all the while upgrading to be public-company ready. For digital asset companies, the matter is further complicated by a host of challenges that often arise from applying current accounting standards and tax regulations to these transactions.

This brief aims to provide an overview of some of the key issues that target companies operating in the digital asset ecosystem need to consider, and be prepared for, if they choose to become a public company through a SPAC acquisition. While not comprehensive, it sketches out terrain that may be unfamiliar to many operating in this space.

1. Who needs SPACs, and why?

Digital asset startups have a unique ability to raise capital through other means and may be generally profitable or sufficiently capitalized out of the gate. But if a company is going to get in the game and be competitive for the long term, in time it will typically need to turn to public markets. This is due in part to increased scrutiny from the SEC, among other regulators. This is not uncommon among disruptive technology companies where early capital is necessary for growing market share at an expedited pace. SPAC mergers may be an effective route to acquiring that capital and going public. Capital is king, whether your company plays in the infrastructure space (e.g., in mining, validating, staking, or functioning as a data center—all to make the crypto universe function) or in the world of trading platforms (e.g., crypto exchanges, NFT platforms, payment processors, emerging custodians or lending platforms—that provide access to the crypto universe).

Many companies in both the infrastructure and trading platform spaces often need capital for:

- Purchase or leasing of hardware
- Building or leasing services from a data center
- Paying electricity bills
- Creating the necessary security processes and protocols
- Paying for maintenance in its many forms

Beyond capital costs and the need for the right human capital, there are a variety of expenses associated with a host of compliance issues, including:

- Complexities of securities laws, as well as pertinent banking rules and regulations
- Increasing regulation and compliance requests from government entities and organizations
- Know your client (KYC) issues, including compliance with the Travel Rule[4]
- Anti-money laundering (AML) requirements

And, of course, there are the many complex issues of governance. Afterall, players in the digital asset ecosystem do not have complete control of their universe. They typically rely on platforms over which they do not have full or direct control. Hence the need for strong governance procedures and practices.

SPACs that are typically created by seasoned management and business leaders, as well as financial services companies, are well positioned to provide the capital and much of the broader guidance that young companies and their founders need in order to go public. In addition, as companies grow, many SPACs can provide access to PIPE (private investment in public equity) investors, those entrepreneurs who can provide additional and vital capital that can help a company to scale up, capture, grow, and maintain market share in a highly competitive arena. Finally, and perhaps most importantly, by their nature and inclination, SPACs may be open to taking greater informed risks in order to realize a higher upside, especially with early stage and emerging companies. Figure 1 sets out several other major considerations when asking the question “Why go the SPAC route?”

Figure 1. SPAC appeal in the digital asset ecosystem

From a CFO's perspective, the distinguishing (and appealing) characteristics of SPAC mergers include:

Upfront pricing	Avoiding exposure	Sharing projections
While a traditional IPO determines its pricing at the end of the process, SPAC sponsors and the operating company negotiate a price upfront, offsetting the risk of market volatility and bad timing. When negotiating with the SPAC sponsor, private companies will need to be cognizant of the financial instruments included in SPAC mergers that often lead to dilutive effects for the owners of the operating company.	The ability to price the deal in the beginning may be especially intriguing to digital asset enterprises that may not want to disclose information about business profits and strategies publicly until a deal has been reached. IPOs typically involve roadshows, with CFOs and other C-suite executives courting prospective investors prior to pricing a deal. With a SPAC merger, however, businesses are not obligated to broadly share information until the general terms of a deal have been struck.	In a traditional IPO, companies may disclose future projections in their registration statement, but few do due to potential liability concerns. In a SPAC, forward-looking projections are often included, and many believe projections included in a SPAC merger do not carry the same potential liability as when included in an IPO. As a result, CFOs who do not expect their companies to manage a profit in the short term may decide to communicate projections to investors in hopes of attracting patient investors. At the same time, those who foresee hypergrowth may capitalize on that trajectory to reach a desirable valuation. An important point to note is that the deck used to present the projections to investors, commonly known as the private investment in public equity (PIPE) deck, must be filed with the SEC, which can review and challenge the projections. Further, the investing community will continue to track those projections inquiring as to how or why a company is or is not meeting those projections.

While it is understood, as mentioned earlier, that a potential benefit of going the SPAC route is that pricing occurs upfront, a challenge unique to the digital asset industry is understanding how a SPAC and the potential PIPE investors will value the company. Pricing a digital asset company depends on a number of factors. The central question is this: Is the company acting essentially as a digital asset manager and hence valuation is based on the assets held? Or is it an operating company that uses crypto for a variety of transactions? In that second case, valuation may rely on more traditional revenue and income metrics such as EBITDA. In these situations, companies may have to consider the impact of the impairment of their digital assets when applying the guidance in Accounting Standard Codification (ASC) 350. Companies also need to comply with the SEC rules related to non-GAAP metrics should they choose to make any adjustments. (**Note:** Any presentation in SEC documents of non-GAAP metrics, including the PIPE deck, requires reconciliation to the GAAP metrics.)

2. Going public in a complex and unclear accounting and regulatory environment

In recent remarks, SEC Acting Chief Accountant Paul Munter acknowledged the questions the SEC has received related to digital assets transactions and noted the importance of judgment in the treatment of digital assets—a sector that now has a total market capitalization of several trillion dollars. In his remarks, he states:

> We remind stakeholders there is an existing accounting framework that is robust and provides a basis to account for and report these assets and related transactions. Application of the existing accounting guidance often requires judgment and depends on the issuer's specific facts and circumstances.[5]

From the perspective of young and emerging digital asset companies seeking to go public, there are a number of basic accounting, tax, control, and legal questions and considerations. This article will not touch on legal considerations but will offer a few insights into the accounting, tax, and control considerations necessary for a public digital asset company newly acquired by a SPAC.

Accounting Challenges

It's worth noting that the more complex the digital asset business is, the more challenges there may be in applying the existing accounting models to those transactions. (See the Deloitte paper, "Corporates using crypto.") Essentially, companies using crypto in a manner similar to a financial asset are required to account for it as a non-financial intangible asset. That, in turn, leads to a number of accounting challenges. One of the more specific impacts is that crypto assets are subject to impairment rules under ASC 350 when the market value for the crypto asset declines, but it cannot be written back up as the market recovers. This often leads to recorded balances within the financial statement that represent the lowest market value in the company's holding period and not the value at the reporting date.

As the American Institute of Certified Public Accountants (AICPA) taskforce laid out in its 2021 guide, *Accounting for and auditing of digital assets*, there are several important implications and challenges associated with that reality. Those challenges may ultimately force companies to adopt even more robust disclosures to describe those transactions both in the financial statements and when speaking with regulators.

In addition, from an SEC reporting perspective, digital asset companies seeking to go public via a SPAC should also be aware of recent staff interpretations issued by the SEC through Staff Accounting Bulletin No. 121 and consider its applicability to the Company's accounting and reporting.

Tax Challenges

Given the scarcity of pertinent court cases, private letter rulings, rules, and, as of yet, full legislation, developing a tax position in the crypto-SPAC universe is often a demanding process. It frequently relies heavily on analogy and judgment. This increases the need for scrutiny of all tax positions for a newly public company.

To be sure, the IRS has issued IRS Rev. Rul. 2019-24, which provides guidance on the tax implications for gross income of "hard forks," and a set of Q&As that provide broad guidance on some 40 topics. But this guidance is not comprehensive for all digital assets and cryptocurrencies, and further clarifications and legislation are in the works.[7] In the starkest of terms then, one might contend that in this space every tax position is potentially an uncertain tax position (UTP). This creates risk in an SEC filing that requires appropriate consideration of disclosures in the registration document, from a tax perspective.

Internal Control Challenges

There is no specifically designed risk and control framework for digital asset companies beyond already existing frameworks such as COSO.[8] But, when it comes to SPACs and digital asset IPOs, the most important considerations are the target company's business processes/model that are unique to digital asset companies. (See the Deloitte-sponsored publication, "Blockchain and internal control: The COSO perspective," for discussion of blockchain and digital asset-specific controls.)

However, one area to focus on, in particular, is the controls around custody of digital assets and auditability of that custody. When SPACs approach a digital asset company, they are certain to want information about how assets are custodied. If a company self-custodies, then robust protocols and processes need to be in place around private key security. If a company relies on a third party, then it's important to check that their System and Organizational Controls (SOC) report provides adequate coverage of crypto-specific controls, in addition to the general IT and business process controls. That can also help the auditor determine the nature of the company's control/ownership of the assets and allow it a level of confidence in its ability to audit the company's assets, among other things. No company wants to be labeled "unauditable." In May 2020, the PCAOB issued a Spotlight, "Audits Involving Cryptoassets," which underscores the need to identify and assess the risks for any material misstatement related to those assets.

Conclusion

Being the target of a SPAC merger can hold immense promise for younger and emerging companies in the digital asset ecosystem. The volume and value of the activity is tremendous. Yet, navigating the complexity of a SPAC merger along with the complexity and innovation that animate this digital asset ecosystem defies easy categorization or solutions. Nevertheless, companies need to be proactive in marshaling and sharing relevant information with investors, users, and capital markets alike. Not only may that help lead to a smoother SPAC process, but it may also enable the company to attract further investment to promote more growth and build greater market share. In addition, there is likely to be a significant cultural realignment—internal and external—among the many different groups and departments, including, but not limited to, the board of directors, the audit committee, risk, corporate reporting, finance, tax, internal audit, operations, controls, technology, and investor relations. Since many of these departments interact with external parties, such as the external auditor, tax, and legal counsel, etc., it is vital that there be corresponding alignment in thinking when dealing with these groups. In the end, one of the key dimensions of building trust is transparency.

How Deloitte can provide assistance

Deloitte has a team of professionals with experience advising companies throughout the life cycle of the SPAC process. We can advise and assist with the following:

- Technical accounting assistance for digital asset companies
- Seller assistance, vendor due diligence, or both
- Implementation of public company GAAP
- Preparation of quarterly financial statements
- Preparation of pro forma financial statements
- Responding to SEC comment letters
- Drafting the MD&A and providing advice on non-GAAP measures
- Evaluating the significance of business acquisitions and the resulting reporting requirements
- Drafting SEC waiver requests (as applicable)
- Assessment and buildup of an internal control environment for public companies
- Assistance with SOX implementation and certification, including blockchain- and digital asset-specific considerations
- Designing automated solutions for financial reporting processes and controls
- Tax planning/UP-C strategy and compliance, including considerations for digital asset companies
- Information technology system assessment and implementation
- Preparation for, and management of, additional audit procedures to conform to PCAOB standards
- Corporate governance structuring and reporting
- End-to-end project management

If you have questions, or to discuss how Deloitte can help, please contact any of the following professionals:

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Endnotes

[1] For a brief overview of Web3, consult the National Public Radio story, "People are talking about Web3. Is it the Internet of the future or just a buzzword?"

[2] For these numbers and others, consult the website, SPAC Research.

[3] Ibid.

[4] The Financial Action Task Force (FATF) created a rule, often referred to as the "Travel Rule" (see page 82 of linked document), which includes an obligation to obtain, hold, and submit required originator and beneficiary information associated with virtual asset (VA) transfers in order to identify and report suspicious transactions, take freezing actions, and prohibit transactions with designated persons and entities.

[5] Paul Munter, "Statement on OCA's continued focus on high quality financial reporting in a complex environment," SEC, December 6, 2021.

[6] Crypto assets as defined by the AICPA in its 2021 guide, Accounting for and auditing of digital assets.

[7] The Biden administration's Infrastructure Bill contains language increasing the tax reporting requirements for cryptocurrency transactions; another bill, introduced by Congressman Don Beyer (D-VA-8), Digital Asset Market Structure and Investor Protection Act, contains many more provisions and currently is under subcommittee review.

[8] Consult the COSO website for the framework.