How you can avoid fraud risks after a de-SPAC

Forensics today
PwC’s angles into the newest risks drawing investigators’ scrutiny today
How you can avoid fraud risks after a de-SPAC

- Special purpose acquisition companies (SPACs) have become a more popular method for private companies to go public due to the distinct advantages they offer over the traditional IPO process.

- However, most companies exhibit material weaknesses and internal control deficiencies within just two years of going public via de-SPAC transactions, according to our analysis.

- To avoid fraud risks, organizations should plan and prepare for public company readiness early in the decision to go public, implement and enhance internal controls, and invest in key areas such as corporate governance, regulatory and compliance risks, human resources and IT, and due diligence.

The key to help avoid fraud risks and material weaknesses after a de-SPAC? Plan and prepare for public-company readiness, and invest in internal controls for the most critical areas.

Special purpose acquisition companies (SPACs) made history last year, with over 600 SPACs raising more than US$145 billion in initial public offerings (IPOs). Over the past few years, SPACs have become a more popular method for private companies who want to go public fast by expediting the traditional IPO process, providing access to additional capital and reducing transaction costs.

These distinct advantages can make de-SPAC merger transactions an attractive option for target companies, the SPACs that acquire them and investors – but they can also introduce risk. In fact, PwC’s research reveals that most de-SPAC companies are likely at greater risk for fraud within just two years of going public due to material weaknesses and internal control deficiencies in a number of key areas.

Defining SPACs & de-SPACs

Special purpose acquisition companies (SPACs): SPACs are shell companies with no actual commercial operations that are created solely for the purpose of raising capital through an IPO to acquire a private company in 18-24 months or face liquidation.

De-SPAC merger transactions: Once a SPAC identifies a target company to acquire, files the appropriate proxy statements and obtains shareholder and approval from the Securities and Exchange Commission (SEC) of the intended merger, the de-SPAC merger transaction is consummated and the de-SPAC is recognized as a public company.
Consider: Identify how de-SPAC transactions can raise fraud risk

Just like any other business, SPACs are subject to internal and external threats that could cause adverse financial, regulatory and reputational damages, from unintentional mistakes to fraudulent financial manipulation.

**PwC research reveals significant risks related to fraud in de-SPACs.** We analyzed annual filings (i.e., Form 10-Ks) issued during 2019 and 2020 for a sample of approximately one-third of the de-SPACs that went public in 2018 and 2019. Our analysis found a lack of internal controls as a consistent issue identified by external auditors and management among these companies.

In our analysis, we found that approximately 91% of the de-SPACs we analyzed reported material weaknesses within just two years of going public.

### The vulnerability of de-SPACS: Where are the weaknesses?

<table>
<thead>
<tr>
<th>Risk Description</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of controls over significant/unusual/non-routine/complex transactions</td>
<td>55%</td>
</tr>
<tr>
<td>Lack of qualified accounting/finance/compliance personnel</td>
<td>42%</td>
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<tr>
<td>Lack of effective controls over segregation of duties</td>
<td>30%</td>
</tr>
<tr>
<td>Poor or weak design and maintenance of information technology general controls</td>
<td>24%</td>
</tr>
<tr>
<td>Lack of formal accounting policies, procedures and controls</td>
<td>24%</td>
</tr>
<tr>
<td>Poor or weak design and maintenance of financial reporting controls/processes</td>
<td>21%</td>
</tr>
<tr>
<td>Others</td>
<td>36%</td>
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</tbody>
</table>

*Source: PwC analysis, 2022*
Triangulating fraud in de-SPACs. The unique nature of SPACs and the de-SPAC transaction process can pose a number of unanticipated and unprecedented opportunities, pressures and rationalizations for fraud. By examining these three elements, we can begin to help identify the parts of an organization that require special attention.

**Conditions for fraud are ripe**

<table>
<thead>
<tr>
<th>Pressure</th>
<th>Opportunity</th>
<th>Rationalization</th>
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<tr>
<td>SPACs have 18-24 months to find and acquire a target company or face liquidation. This creates pressure for SPACs, SPAC sponsors, and target companies to complete the transaction within a compressed time frame and to deliver financial results that meet investor expectations. The resulting temptations are twofold: to conduct limited and/or inadequate due diligence procedures to complete the transaction quickly, and to present financial results that run the risk of misleading investors and overhyping the target company.</td>
<td>Nonexistent or ineffective internal controls put companies at higher risk or both errors and fraud. In our analysis, de-SPACs reported material weaknesses and control deficiencies in: • accounting policies, procedures and controls • financial reporting controls and processes • segregation of duties in relevant accounting controls • design and maintenance of information technology controls • qualified accounting, finance or compliance personnel</td>
<td>The amount of time and effort SPACs, SPAC sponsors, and target companies have to devote to everything leading up to the de-SPAC transaction may translate into an important justification or incentive to ensure the transaction moves forward at any cost. This is particularly true for SPAC sponsors, who receive a significant stake in the merged entity following a de-SPAC transaction.</td>
</tr>
</tbody>
</table>

Source: PwC analysis, 2022.

These contributing factors have not gone unnoticed by the SEC. In 2021, the SEC announced charges against a SPAC, its sponsor, its CEO and the SPAC’s proposed merger target (including its founder) for misrepresenting investors about the target’s technology as well as for its ability to secure required governmental licenses essential to its operation.

On March 30, 2022, the SEC proposed SPAC rule amendments to require enhanced reporting and disclosures and extend investor protection afforded to IPOs to de-SPACs. These requirements could lead to more investigations and restatements for de-SPAC companies. We also expect to see an increase in Form 12b-25s (Notice of Late Filing) issued by de-SPAC companies notifying the public that the company will miss its Form 10-Q or Form 10-K filing deadline. This has the potential to trigger a loss in investor confidence.

When fraud allegations do arise, the impact is usually significant. Considering costly investigations, fines and penalties, litigation and regulatory inquiries and falling stock prices, perhaps the biggest negative impact following fraud is damage to the company’s reputation.

But do SPACs and their target merger companies have the time and resources to invest in fraud prevention up front? With growing pressure to de-SPAC as quickly as possible, some companies might answer ‘no’. Investing in corporate governance and internal controls is time consuming, but it’s often far less disruptive than dealing with an incident or allegation after it occurs. Simply put, organizations that are better prepared before a de-SPAC tend to have fewer fraud risks and material weaknesses afterwards.
Once management signs a letter of intent, target companies typically have four to nine months to get ready to begin operating as a public company. To demonstrate public company readiness, organizations need to understand compliance and reporting obligations, identify gaps and address them by investing in key functional areas.

**Understand compliance and reporting obligations.** While a shorter timeline means the target company becomes publicly traded sooner, set deadlines place a higher burden on the organization and its management. Most of the information comprising SPAC filings come from the private company, which will need to comply with periodic reporting obligations immediately after closing the transaction. This includes filing a current report on Form 8-K including historical financial statements and associated pro formas within four business days of closing.

When it comes to compliance and regulatory requirements, organizations need to give themselves adequate time to plan and prepare not only for the de-SPAC transaction itself, but also for what comes after.

**Identify gaps.** Once a target company has a better understanding of the compliance and reporting requirements involved in a de-SPAC transaction, it can begin to identify where internal controls are missing or deficient. To be successful, companies need to start early and address any gaps in advance of going public. Hurrying through this process once the de-SPAC is initiated exposes the company and its investors to more risk.

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**Do now: Plan and prepare for public company readiness**

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Do next: Invest in key areas

All companies going public need to implement effective internal controls, but each organization faces its own set of risks and must execute a custom plan. We recommend that SPACs focus on investing in the following four critical areas.

Due diligence. A central theme in SPAC litigation and enforcement actions, adequate due diligence can help identify issues such as conflicts of interest, false and misleading statements, and deficiencies in internal controls. As a rule, SPACs, SPAC sponsors and SPAC management teams should not take business representations from the target company at face value and must validate the representations independently. If they fail to conduct sufficient due diligence and repeat unsubstantiated claims made by the target company to the market, they will be held accountable.

Corporate governance. Many companies that have recently completed a de-SPAC transaction lack effective corporate governance, resulting in higher fraud risks. Fraud allegations often come as a surprise. They catch organizations that are unprepared, and dealing with them takes time. Organizations need to be able to investigate allegations thoroughly, discreetly and quickly to avoid losing control of the situation. In many cases, this means getting help from professional, independent and experienced forensics specialists and outside counsel. It’s important for organizations to remediate any issues identified and to emerge stronger from the investigation to reduce future risks.

Regulatory and compliance risks. Companies going public cannot simply pick off-the-shelf compliance programs and procedures. In addition to the filing requirements that come along with de-SPAC transactions, organizations need customized compliance programs to deal with the specific business, industry and structural risks they face.

Start with a thorough risk assessment. Analyzing assets and liabilities can help organizations prepare themselves to mitigate existing risks and better manage them in the future. For example, a domestic company that sells on a direct basis and has little interaction with government officials will likely have lower bribery and corruption risk. On the other hand, a company with a growing international footprint that utilizes a complex sales channel and has significant interactions with government officials would likely have high bribery and corruption risk and would need to have a compliance program in place to manage this risk.

Human resources and IT. To avoid any missteps during the process of planning and preparing for a de-SPAC, organizations need to make sure that they have people with the requisite skills as well as the information technology necessary to be able to perform these functions. For example, without the right talent and infrastructure, meeting public reporting deadlines is challenging. Notices of late filing may be viewed as a red flag that the company has a significant issue.

To augment these capabilities, companies will need managerial support. Investing in the right people and the right technology can be expensive, so organizations also need to demonstrate how this investment will reduce risk.
Bottom line: Act now to minimize risk of fraud and material weaknesses

Waiting until the last minute to do all of the above can have detrimental consequences for the target company, SPAC sponsors and investors, and the merged de-SPAC after the transaction is complete. Private companies that want to go public are typically interested in doing so because they want to increase their value – but fraud and its associated risks can be a costly distraction. To be sure, de-SPAC transactions can put organizations on the fast track to public trading, but lack of preparedness could prove to be a serious setback and derailed business growth.
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