NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

TO: Kevin Fry, Chair, Valuation of Securities (E) Task Force
Members of the Valuation of Securities (E) Task Force

FROM: Charles A. Therriault, Director, NAIC Securities Valuation Office (SVO)
Marc Perlman, Managing Investment Counsel, NAIC Securities Valuation Office (SVO)

CC: Eric Kolchinsky, Director, NAIC Structured Securities Group (SSG) and Capital Markets Bureau
Rosemarie Kalinowski, Sr. Analyst, NAIC Securities Valuation Office (SVO)
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RE: Addition of Spanish GAAP in the list of Countries and Associated National Financial Presentation Standards (the List) in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual")

DATE: September 1, 2021

Summary - At present, financial statements submitted to the Security Valuations Office (SVO) for analysis must be audited and prepared in accordance with either a Global Financial Presentation Standard (US Generally Accepted Accounting Principles (US GAAP) or International Financial Reporting Standards (IFRS) or a Reconciled Financial Presentation Standard (local GAAP reconciled to US GAAP or IFRS) unless the SVO has been specifically authorized to use a National Financial Presentation Standard.

Currently, the SVO is authorized to accept audited financial statements prepared in accordance with the following National Financial Presentation Standards:

- Canadian Accounting Standards for Private Enterprises but only for non-financial institutions.
- UK Financial Reporting Standard (FRS) 102 (which encompasses Irish companies reporting under FRS 102).
- Australian GAAP.
- German GAAP.
- French GAAP but subject to the presentation of additional documentation as specified above and annually thereafter as specified below.
- Dutch (Netherlands) GAAP.
- Italian GAAP but subject to the presentation of additional documentation as specified above and annually thereafter as specified below.
- Belgian GAAP.

- Swiss GAAP FER presented on the basis of the whole body of rules and regulations of Swiss GAAP FER ("Core FER" and other Swiss GAAP FER Standards), but subject to the presentation of additional documentation as specified in this Manual.

In 2013, the Valuation of Securities (E) Task Force adopted a procedure, as outlined in Part Two, paragraph 174 of the *Purposes and Procedures Manual* (P&P Manual) of the NAIC Investment Analysis Office, to submit requests to consider other National Financial Presentation Standard as follows:

> *A national insurance association (but not individual insurers or other persons) may, by written request, ask the SVO to study the feasibility of adding a country and the associated National GAAP or National IFRS. The SVO is authorized, but not required, to hold discussions with representatives of the national insurance association to evaluate whether the criteria specified below has been met and to formulate a recommendation to the VOS/TF. The SVO may not assign an NAIC Designation to or otherwise assess a security under the proposed national standard until the VOS/TF has, by amendment to this Manual, added the proposed country and the associated National GAAP or National IFRS.*

In March 2021, the SVO received a letter from the American Council of Life Insurers (ACLI) requesting the SVO to consider the National GAAP/National IFRS of Spain for addition to the National Financial Presentation Standards. This letter included information supporting the request as required in Part Two, paragraph 175, of the P&P Manual, including evidence that certain companies in the targeted country are not required to use a Global Financial Presentation Standard, and that investment opportunities exist in the targeted country.

Having received the industry request and required information, Part Two, paragraphs 177-181 of the P&P Manual further establishes a process that the SVO must follow in order to have a National GAAP or National IFRS accepted as a National Financial Presentation Standards. The steps in this process are as follows:

> *177. The national insurance association will, as necessary, identify an accounting firm that is an expert in the national accounting system of the country proposed for inclusion on the List of Countries and associated National Financial Presentation Standard.*
>
> > The requirement of this step has been fulfilled. The ACLI identified Deloitte of Spain as an expert in the national accounting system of Spain.
>
> *178. The national insurance association will work with the SVO to create an educational session on those aspects of financial presentation relevant to the SVO for purposes of its credit risk assessment.*
>
> > This requirement has been fulfilled. On June 22, 2021, Joaquin Sánchez-Horneros, Director and member of the IFRS Centre of Excellence of Deloitte Spain, along with Pablo Castillo Lekuona, Senior Manager in the Department of Global Capital Markets and Accounting IFRS, gave a presentation to SVO analysts.

179. The educational session will focus on the material differences between accounting methods for the income statement and balance sheet, and shall include such further or additional areas as the SVO shall deem necessary in view of the specific country and national accounting system proposed.

> The June 22, 2021 presentation by Deloitte included detailed differences between Spanish GAAP and IFRS including a case study demonstrating the financial statement impact on a company over three years, comparing IFRS to Spanish GAAP. The case study demonstrated the adjustments required to bridge from one standard to another, although no one given example is necessarily representative of the absolute magnitude of difference on financial measures for any other company.

180. At the conclusion of such educational session, the SVO shall assess whether the educational session provides a sufficient basis for it to make needed adjustments to the financial information presented under the national accounting standard.

> Based on the Deloitte presentation, including the reconciliation case study, it appears that most differences between Spanish GAAP and IFRS can be identified with additional disclosure sufficient to allow an analyst to make any necessary adjustments to an analysis. As noted below, the SVO will request additional information if the footnotes to the financial statements prepared in accordance with Spanish GAAP fail to provide adequate information.

181. The SVO shall then assess whether the application of the adjustments in one or more transactions confirms that the use of the national accounting standard leads to the creation of NAIC Designations analogous (in the information they convey about credit risk) to those created by the use of a Global Financial Presentation Standard.

> The presentation of the Spanish GAAP review by Deloitte was sufficient for the SVO to draw conclusions as to the ability to analyze credits presented under these accounting guidelines.

The principal differences between Spanish GAAP and IFRS focus on several categories:

- **Operating Leases**
  - o Spanish GAAP: Not brought on to the balance sheet; accounted for as operating leases. Operating lease income and expense corresponding to the lessor and lessee are considered respectively, to be income and expenses of the year in which they accrue.
  - o IFRS: Brought on to the balance sheet. Recorded as an asset (right of use) and a corresponding lease liability by the lessee.
  - o Impact: Lessor: income is higher / Lessee: income is lower than that reported for IFRS and debt is lower than that of IFRS.
- **Government Grants**
  - o Spanish GAAP: Initially accounted for as equity and subsequently charged to the income statement as amortization over time.

- IFRS: Prohibits recognizing them immediately as equity. In the case of capital grants, it is allowed to record them by reducing assets. Grants related to expenses can be presented in the income statement as income or netting the corresponding expenses.
- Impact: Equity will be inflated for capital grants and related debt to cap will be lower than that calculated under IFRS. Net income will be lower in each subsequent year than that under IFRS calculation but should be reconcilable if footnotes provide disclosure.

- **Intangible Assets**
  - Spanish GAAP: Research & development costs can be capitalized. Presumption of a useful life limit of 5 years in the amortization of these costs and computer programs, unless proven otherwise.
  - IFRS: Research costs are not capitalized. Only development costs can be capitalized under certain requirements, which will be amortized over their useful life (no time limit).
  - Impact: Assets are higher than under IFRS since research is capitalized; net income will be lower than under IFRS in each subsequent year due to amortization of research. However, this should be reconcilable if footnotes provide disclosure.
- **Goodwill**
  - Spanish GAAP: Amortizable over 10 years.
  - IFRS: Not amortizable. If fair value goes below historical cost, an impairment must be recorded.
  - Impact: Net income is lower than under IFRS due to ongoing goodwill amortization; assets and equity will be undervalued relative to IFRS due to the amortization. Debt to cap calculations will be higher than under IFRS due to the lower equity. However, this should be reconcilable if footnotes provide disclosure.
- **Financial instrument-valuation**
  - Spanish GAAP:
    - Financial assets: lower of acquisition cost and market
    - Financial liabilities: repayment value
    - Financial liabilities: all changes in fair value are recognized in the income statement
  - IFRS:
    - Financial assets: fair value
    - Financial liabilities: amortized cost
    - Financial liabilities: changes in fair value are recognized in equity
  - Impact:
    - Financial assets: Asset value will be understated relative to IFRS if fair value and cost are different.
    - Financial liabilities: Changes in fair value will impact the income statement under Spanish GAAP, which could affect financial ratio calculations involving net income, such as net income/revenues, as well as the calculation of EBITDA if these adjustments cannot be clearly identified in the footnote disclosure.
- **Financial instruments (available for sale): Impairment/reorganization**
  - Spanish GAAP: Fresh start in certain situations

  - IFRS: Fresh start is not recognized.
  - Impact: reported assets under Spanish GAAP may be overstated, but this is an item that is likely to occur infrequently and can be identified by footnote disclosure.
- **Joint ventures**
  - Spanish GAAP: Proportionate consolidation, if 50/50 joint venture can use equity method.
  - IFRS: Uses equity method.
  - Impact: Revenue and operating income will be higher than under IFRS if proportionate consolidation is used. This may significantly distort results if a company has large joint venture holdings. Footnote disclosures would be needed outlining information on the holdings that would enable the analyst to adjust the results to carve out joint ventures as equity holdings.

The conclusion is that there are several important differences between Spanish GAAP and IFRS. The items referenced above will require additional disclosures in the notes or audited supplement to the financial statements, thereby allowing the SVO to adjust the financial statements so that the use of Spanish GAAP financial statements will have no impact on the ultimate designation. Some of these disclosures may not be contained in the notes to Spanish GAAP financial statements, so the following items, certified by the auditor, should be submitted along with the Spanish GAAP statements:

- A complete set of audited financial statements (for at least three years, if available) comprising: balance sheet, income statement and consolidated statement of cash flows;
- Disclosure of operating lease commitments in a manner similar to that required by IFRS or US GAAP;
- Disclosure of Government Grants, initial amount and year-to-date and cumulative amortization;
- Disclosure of gross capitalized research costs and cumulative amortization;
- Disclosure of gross goodwill and cumulative amortization, including goodwill created by fresh-start accounting;
- Disclosure of the change in fair value for financial assets and liabilities;
- Disclosure on joint ventures not using the equity method including full financial results;

Proposed Amendment - The text changes to include Spanish GAAP on the list of Countries and Associated National Financial Presentation Standards is shown below with additions in red underline and deletions in ~~red strikethrough~~, as it would appear in the 2020 P&P Manual format.

PART TWO
OPERATIONAL AND ADMINISTRATIVE INSTRUCTIONS APPLICABLE TO THE SVO

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Information Requirements Associated with the Use of a National Financial Presentation Standard

182. Insurance companies who file securities whose issuers present financial information in accordance with a National Financial Presentation Standard shall:

- Where materially different from Global Financial Presentation Standards, identify how local accounting standards treat specific issues relevant to assessment of credit risk.
- Provide written descriptions of the accounting difference the insurer considered, and of how it resolved concerns about the accounting differences during the investment decision making process.
- Be prepared to provide the SVO with access to the issuer's management or to convey questions and retrieve information from the issuer's management.
- Include a consolidated statement of cash flows for the past three years. See the definition of Audited Financial Statement for additional guidance pertaining to this requirement.
- For filings presented on the basis of French generally accepted auditing standards GAAP, the following additional documentation is required:
  - Disclosure of finance lease obligations;
  - Disclosure of operating lease commitments in a manner similar to that required by IFRS ~~IRFS~~ or US GAAP;
  - Disclosure of pension assets and liabilities as well as any other post-employment plan obligations (key is disclosure of any unfunded amount);
  - Disclosure of the amount of treasury stock, if any, and how it is accounted for; and
  - Segment reporting of sales, assets, income and depreciation.
- For filings presented on the basis of Italian GAAP, the following additional documentation is required:
  - A consolidated statement of cash flows for three years;
  - Disclosure of finance lease obligations;

- Disclosure of operating lease commitments in a manner similar to that required by IFRS ~~IRFS~~ or U.S. GAAP;
- Disclosure of pension assets and liabilities, as well as any other post-employment plan obligations, especially of any unfunded amounts; and
- Disclosure of the amount of Treasury stock, if any, and how it is accounted for.

▪ For filings presented on the basis of the whole body of rules and regulations of Swiss GAAP FER ("Core FER" and other Swiss GAAP FER Standards), the insurer always provides the following information:

- Full set of audited financial statements, including a statement of cash flows;
- Disclosure of finance lease and operating lease commitments in a manner similar to that required by IFRS ~~IRFS~~ or US GAAP;
- Disclosure of pension assets and liabilities as well as any other post-employment plan obligations, especially any unfunded amount;
- Disclosure of the amount of treasury stock, if any, and how it is accounted for;
- Segment reporting of sales, assets, income and depreciation;
- Signed Auditor's Opinion; and
- Consolidation information and consolidated financial statements where relevant.

▪ For filings presented on the basis of Spanish GAAP, the following additional documentation is required:

- A complete set of audited financial statements (for at least three years, if available) comprising: balance sheet, income statement and consolidated statement of cash flows;
- Disclosure of operating lease commitments in a manner similar to that required by IFRS or US GAAP;
- Disclosure of Government Grants, initial amount and year-to-date and cumulative amortization;
- Disclosure of gross capitalized research costs and cumulative amortization;
- Disclosure of gross goodwill and cumulative amortization, including goodwill created by fresh- start accounting;

- Disclosure in the change in fair value for financial assets and liabilities;
- Disclosure of joint ventures recorded not using the equity method, including full financial results;

Countries and Associated National Financial Presentation Standards

183. The SVO is authorized to accept Audited Financial Statements prepared in accordance with the following National Financial Presentation Standards:

- Canadian Accounting Standards for Private Enterprises but only for non-financial institutions.
- UK Financial Reporting Standard (FRS) 102 (which encompasses Irish companies reporting under FRS 102).
- Australian GAAP.
- German GAAP.
- French GAAP but subject to the presentation of additional documentation as specified above and annually thereafter as specified ~~below~~ in this Manual.
- Dutch (Netherlands) GAAP.
- Italian GAAP but subject to the presentation of additional documentation as specified above and annually thereafter as specified ~~below~~ in this Manual.
- Belgian ~~Belgium~~ GAAP.
- Swiss GAAP FER presented on the basis of the whole body of rules and regulations of Swiss GAAP FER ("Core FER" and other Swiss GAAP FER Standards), but subject to the presentation of additional documentation as specified in this Manual.
- Spanish GAAP but subject to the presentation of additional documentation as specified above and annually thereafter as specified in this Manual.