Baker McKenzie.

Alert | Tax

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NEW ACCOUNTING CONSIDERATIONS FOR 2021

Royal Decree 1/2021, dated 12 January, which amends Spain's Generally Accepted Accounting Principles (GAAP) and the regulations that develop it.

On 30 January 2021, Spain's Official State Gazette published Royal Decree 1/2021, which established **certain amendments in Spain's Generally Accepted Accounting Principles (*El Plan General de Contabilidad or "PGC"*), such as the GAAP for Small and Medium Sized Businesses (SMBs), the rules for preparing Consolidated Annual Financial Statements and the rules for adapting the GAAP to non-profit institutions.**

With regard to fiscal years starting **after 1 January 2021,** a number of amendments have been made to Spain's domestic accounting regulations, mainly to align them with the most recent international accounting criteria for financial instruments and revenue recognition, as such are set out in International Financial Reporting Standards 9 and 15 (IFRS-EU 9 and IFRS- EU 15) of the GAAP. This Alert addresses the amendments made to the GAAP in general, with some references to the GAAP for SMBs[1].

1. Fair value

This term has been amended and the aspects to be taken into account to calculate the fair value, as stipulated in Section 6.2 (Measurement Criteria) of the GAAP's Part 1 (Conceptual Accounting Framework), are now more comprehensive.

The RD defines Fair value as "*the price that would be received to sell an asset or which would be paid to transfer or settle a debt in an orderly transaction between market participants at the measurement date".*

With regard to calculating the fair value, the following considerations have been added:

- fair value is estimated for a certain date, and may change over time
- account should be taken of the conditions that market participants would bear in mind for the relevant element (e.g. state of repair, location, restrictions on sale or on use).
- in the case of non-financial assets, their capacity to generate economic benefits in a scenario of best and maximum use must also be taken into account
- the transaction is assumed to be carried out by interested and duly informed parties who are mutually independent and acting at arm's length
- the transaction is assumed to take place in the principal market for the asset or liability (the market with the highest volume and level of activity in which the company would normally transact) and, in the absence of such a market, in the most advantageous market to which the company has access (the market that maximises the amount that would be received from the sale of the asset or minimises the amount that would be paid for the transfer of the liability, after taking into account transaction costs and carrying charges).

[1] This alert will only deal with the measurement and recording criteria of the GAAP (Royal Decree 1514/2007), and will not include the changes in the annual financial statements (3rd Part of the GAAP), except for some references to the annual report. It will not address the changes in the chart of accounts either (4th Part SPANISH GAAP) nor those involving definitions and accounting relationships (5th Part SPANISH GAAP). The amendments made to the GAAP (General Chart of Accounts) for Small and Medium-sized Enterprises has also been mentioned (RD 1515/2007).
This alert does not address the amendments made to the Rules for the preparation of consolidated annual financial statements (RD 1159/2010) nor the Rules for adapting the GAAP (General Chart of Accounts) to non-profit entities (RD 1491/2011).

The following hierarchy is established with regard to using estimates to calculate fair value:

- Level 1: estimates using unadjusted quoted prices for identical assets or liabilities in active markets to which the firm has access at the measurement date.
- Level 2: estimates using quoted prices from active markets for similar instruments or other measurement methodologies where all significant inputs are based on directly or indirectly observable market data.
- Level 3: estimates where any significant variable is not based on observable market data.

Finally, the RD no longer allows fair value to be equated to amortised cost, or to acquisition or production cost, for those items that cannot be measured.

2. Standards for classifying and measuring financial instruments

Royal Decree 1/2021 amends Recognition and Measurement Standard 9 of the GAAP.

2.1 Classification of financial assets

Financial asset classification has been simplified in terms of measurement, the prior six categories have been reduced to four, as set out in the comparative chart below:

New categories	Previous categories
Financial assets at fair value via changes in P+L	Financial assets held for trading Other financial assets at fair value via changes in P+L
Financial assets at amortised cost	Loans and receivables Investments held to maturity
Financial assets at fair value via changes in net equity	Financial assets available for sale
Financial assets at cost	Equity investments in group companies, jointly controlled companies and associates

2.2 Criteria for classifying financial assets in the different categories

Category	Criteria
Financial assets at fair value via changes in the profit and loss statement	The **general rule** is that all financial assets are included in this category unless they are classified in one of the other categories. **Financial assets held for trading are mandatorily included in this category**, defined as those that (i) are acquired for the purpose of selling them in the short term; (ii) form part of a portfolio shown to be aimed at short-term profit; or (iii) are a derivative (except for financial guarantees or hedging instruments). Any financial asset other than investments in group companies, jointly-controlled companies and associates may be classified as a financial asset at fair value via changes in the profit or loss statement, if this eliminates or mitigates measurement inconsistencies or accounting mismatches.

Category	Criteria
Financial assets at amortised cost	Includes financial assets (even if they are admitted to trading on an organised market) that are comparable to **an ordinary or common loan** and the aim is to receive cash flows from performing the contract, consisting solely of principal and interest payments. Generally, this category includes trade and non-trade receivables, as well as bonds with a specific maturity date and for which a variable market interest rate is charged and may be subject to a cap. The following do not fall into this category: (i) instruments that may be converted into the issuer's equity instruments; (ii) loans with variable interest rates that are inverse to market rates; (iii) those where the issuer may defer interest payment, if such payment would affect the issuer's creditworthiness, without the deferred interest accruing additional interest. The scope of application is outlined following IFRS-EU 9, clarifying that, in the case of a group of items, not all the instruments need to be held to maturity. In addition, a company may have more than one policy for managing its financial instruments and may segregate a portfolio of financial assets to reflect the level at which the financial assets are managed.
Financial assets at fair value via changes in net equity	This category includes assets whose contractual terms give rise, at specific dates, to cash flows that are only **collections of principal or of the interest** owed on the outstanding principal amount, if said assets are not held for trading or classified at amortised cost. There is an **option to irrevocably classify** an equity instrument in the fair value portfolio via changes in net equity, if the instrument is not held for trading or measured at cost. The classification must be made at the initial recognition date and the instrument may not be reclassified out of the fair value portfolio via changes in the profit and loss statement.
Financial assets at cost	Included are (i) equity investments in group companies, jointly-controlled companies and associates, (ii) equity instruments whose fair value cannot be determined by reference to a quoted price (or which cannot be estimated in a reliable manner) and the derivatives arising from such investments, (iii) hybrid financial assets whose fair value cannot be reliably estimated, unless the requirements for accounting at amortized cost are met (iv) contributions under joint-venture and similar contracts, (v) profit-sharing loans with contingent interests, and (vi) any other financial assets that are initially classified in the fair value portfolio via changes in the profit and loss statement, when it is not possible to obtain a reliable estimate of their fair value.

2.3 Measurement of financial assets

As to the **initial measurement** of each category, they are generally measured at fair value or cost, which will be the transaction price including directly attributable transaction costs, except in those cases where the financial assets are at fair value via changes in the profit and loss statement, where such costs will be recognised in the profit and loss statement for that year[2].

The **subsequent measurement** of the assets will be carried out as specified in the title of each category, with certain clarifications that depend on the category and type of financial asset involved. In general, the provisions are the same as those set out in the previous GAAP.

Although IFRS-EU 9 introduced changes in **impairment**, moving from a model based on incurred loss to another based on the concept of expected loss, this Royal Decree does not introduce these new features and generally maintains the criteria previously applied. In any case, it is worth recalling the following two clarifications regarding losses from the impairment of equity instruments, which continue to appear in the amended GAAP, albeit in different categories:

[2] There are further clarifications, exceptions and specifications regarding this general equivalence in the financial asset categories.

- In the case of equity instruments recognised in the fair value portfolio via changes in net equity, the RD stipulates that reversing decreases in fair value that were recognised through the profit and loss statement (due to the fact that there was objective evidence of asset impairment) will now be recognised directly through net equity and not via the profit and loss statement.
- In the case of equity instruments recorded at cost, it is established that, in general, the indirect estimation method (based on net equity) may be used, if it allows a minimum recoverable value to be demonstrated without further complex analyses and when there is no impairment.

2.4 Reclassification of financial assets

The amended GAAP further develops **financial asset reclassification**, establishing that assets may be reclassified with potential effect as of the date on which they change category, provided that the company changes the way it manages such assets to generate cash flows (changes in certain hedging instruments are excluded from these "reclassifications").

The following rules are specified, depending on the categories involved:

- Financial assets at amortised cost → Financial assets at fair value via change in the profit and loss statement: The fair value shall be measured at the date of reclassification and any gain or loss on the difference between amortised cost and fair value shall be recognised in the profit and loss statement.
- Financial assets at fair value via change in the profit and loss statement → Financial assets at amortised cost: The fair value at the reclassification date shall be their new carrying amount.
- Financial assets at amortised cost → Financial assets at fair value via changes in equity: The fair value shall be measured at the date of reclassification and any gain or loss on the difference between amortised cost and fair value shall be recognised in net equity.
- Financial assets at fair value via changes in equity → Financial assets at amortised cost: The fair value at the reclassification date will be their new carrying amount, adjusted for cumulative changes in the net equity value up to the reclassification date (as if the assets had been measured at amortised cost from inception).
- Financial assets at fair value via changes in the profit and loss statement → Financial assets at fair value via changes in equity: This reclassification is not permitted in the case of equity instruments, in all other cases they continue to be measured at fair value.
- Financial assets at fair value via changes in equity → Financial assets at fair value via change in the profit and loss statement: They continue to be measured at fair value and accumulated changes in the net equity value will be reclassified to the profit and loss statement at that date.
- Investments in equity instruments measured at cost → Financial assets at fair value via changes in profit and loss: When equity instruments are no longer considered an investment in a group company, jointly-controlled company or associate, they will be classified as financial assets at fair value via changes made to the profit and loss statement, provided that the fair value of the shares can be estimated in a reliable manner, unless it is decided to classify as fair value via changes in net equity.
  Fair value is measured at the date of reclassification and any difference existing between the cost and fair value is recognised in the profit and loss statement or in net equity, depending on which classification option is chosen.
- Financial assets at fair value via changes in profit and loss → Investments in equity instruments measured at cost: If the fair value of an equity instrument is no longer reliable, its fair value at such date will become its new carrying amount.

2.5 Recognition of interest and dividends

The RD clarifies that to decide if a dividend should be recognised as income or as a recovery of the investment, only the profits recognised in the individual profit and loss statement since the acquisition date shall be taken into account, unless it is evident that the dividend should be classified as a recovery of investment from the shareholder's perspective.

2.6 Financial liabilities

The amended GAAP also simplifies the **financial liability categories,** as set out below:

New categories	Previous categories
Financial liabilities at amortised cost	Debts and payables
Financial liabilities at fair value via changes in the profit and loss statement	Financial liabilities held for trading Other financial liabilities at fair value via changes in the profit and loss statement

Before analysing the criteria for classifying financial liabilities in more detail, it should be noted that the rights, options or warrants necessary to acquire one's own equity instruments are deemed equity instruments, provided that said rights, options or warrants are offered to all the company's shareholders or partners. If they can be settled by delivering the relevant equity instruments or cash, then they meet the definition of a "financial liability".

Category	Criteria
Financial liabilities at amortised cost	The general rule is that all financial liabilities are included in this category, unless they are classified as fair value via changes in the profit and loss statement. Among other liabilities, this category include trade and non-trade payables and profit-sharing loans that have the characteristics of ordinary loans, even if there interest rate is zero or below market rates.
Financial liabilities at fair value via changes in the profit and loss statement	Financial liabilities held for trading are included if they are (i) issued with the aim of their being reacquired in the short term; (ii) related to a short seller's obligation to deliver financial assets that have been lent to it; (iii) part of a portfolio that can be shown to have the aim of obtaining short-term profit; or (iv) a derivative (except for financial guarantees or hedging instruments). Financial liabilities may be irrevocably included in this category upon initial recognition if they (i) eliminate or mitigate measurement inconsistencies or accounting mismatches, (ii) are a group of liabilities that are managed in accordance with a fair value-based strategy, or (iii) are hybrid financial liabilities that meet the requirements of paragraph 5.1 of Recognition and Measurement Standard 9.

The **initial measurement** of financial liabilities shall be made at fair value, i.e. at the transaction price. In the case of financial liabilities at amortised cost, transaction costs are included, whereas in the case of financial liabilities at fair value via changes in the profit and loss statement, such costs are recognised directly in the profit and loss statement.

The **subsequent measurement** of financial liabilities shall be made either at amortised cost or in the profit and loss statement depending on the category in which they are classified.

Financial liabilities may not be reclassified, and certain hedging instruments that no longer qualify or no longer qualify as hedges may not be reclassified either.

With regard to the **derecognition of financial liabilities**, the effects of certain changes established for calculating cash flows from debt instruments is a new feature that may cause substantial changes in the relevant financial liability.

2.7 Hybrid financial instruments

A distinction is made between the treatment of hybrid contracts where a financial asset is the host contract and the treatment of other hybrid contracts.

2.8 Contracts held in order to receive or deliver a non-financial asset.

They will be treated as prepayments or commitments for purchases or sales unless they can be settled by differences and are classified as measured at fair value through profits or losses. A put or call option on a non-financial asset that can be settled net in cash, in another financial instrument or by exchanging financial instruments is also treated in accordance with the derivative financial instruments standard.

2.9 Financial guarantee contracts

It is stated that the bonded company will recognise the cost of the guarantee in the profit and loss statement as an operating expense, unless a corresponding accrual is required. However, if the guarantee is directly linked to a financial transaction (for example, if the interest rate depends on the guarantee), the loan and guarantee may be treated as a single financial transaction for the company and all disbursements arising from the guarantee should be included in the calculation of the effective interest rate of the transaction.

2.10 Accounting hedges

The Spanish GAAP is adapted to the international reform (IFRS-EU 9), which seeks to align accounting outcome and risk management in companies, introducing greater flexibility in the requirements to be met.

Issues such as how to treat the time value of options and the forward element of forward contracts have not been included in Recognition and Measurement Standard 9 of the Spanish GAAP. However, it should be considered that, in accordance with section 7 of the Conceptual Accounting Framework, the preamble of the Royal Decree states that "in the absence of a specific regulatory development on this matter, the company must apply the new criteria on hedge accounting developed in the accounting regulations for credit institutions for preparing the individual annual accounts for financial years starting on or after 1 January 2021, with the necessary adaptations to take into account the financial instrument classification criteria of the Spanish GAAP" (see Bank of Spain Circular 4/2017, dated 27 November, sent to credit institutions on public and confidential financial reporting standards and financial statement formats).

It is stated that all of the following conditions must be met for the company to apply hedge accounting:

- The hedging relationship consists only of hedging instruments and eligible hedged items: in addition to derivatives, financial assets and financial liabilities that are not derivatives may also be designated as hedging instruments if they are measured at fair value and changes in their valuation are recognized through the profit or loss statement. However, a written option may not be designated as a hedging instrument unless it is designated to hedge a purchased option, including those purchased options embedded in another financial instrument. Recognised assets and liabilities, unrecognised firm commitments, highly probable forecast transactions (when they involve an exposure to changes in cash flows that could affect the income statement) and net investments in foreign operations that expose the company to specifically identified risks of changes in fair value or cash flows may be designated as hedged items. An aggregate exposure consisting of a combination of an exposure that qualifies as a hedged item as described above and a derivative may also be designated as a hedged item.
- The hedging relationship is designated and documented at the outset, at which time its objective and strategy must also be set: documentation of a hedging relationship must include identification of the hedging instrument and the hedged item, the nature of the risk to be hedged, and how the firm will assess whether the hedging relationship meets the hedge effectiveness requirements.
- The hedge must be effective for the entire expected lifetime to offset changes in fair value or cash flows attributable to the hedged risk, consistent with the risk management strategy initially documented. Once

the hedge effectiveness requirement is met, the portion of the hedging instrument that is not used to hedge a risk is accounted for in accordance with the general criteria.

If a hedging relationship no longer meets the hedge effectiveness requirement for the hedge ratio, but the risk management objective for that designated hedging relationship remains unchanged, the company will adjust the hedge ratio of that hedging relationship so that it again meets the required criteria, referred to in this standard as rebalancing.

Rebalancing means that, for the purposes of hedge accounting, once a hedging relationship starts, the company must adjust the amounts of the hedging instrument or hedged item to respond to changes that affect the corresponding hedge ratio.

2.11 First application criteria for transitional arrangements

Transitional Provision 2 establishes the following criteria for first-time application of the amendments to the classification and measurement of financial instruments and hedge accounting in the first financial year starting on or after 1 January 2021:

- Barring exceptions, amendments must be applied retroactively in accordance with Recognition and Measurement Standard 22.
- The date of first application will be the beginning of the first financial year starting on or after 1 January 2021.
- The facts and circumstances that exist at the date of first application will be taken into account to classify financial assets. The resulting classification will be applied retrospectively regardless of how the company managed its financial assets in prior reporting periods.
- The option to designate or revoke the classification of a financial instrument as at fair value through profits and losses may be exercised at the date of initial application. These designations and revocations must be done on the basis of the facts and circumstances that exist at the date of initial application. The resulting classification shall be applied retrospectively.
- Expedients are provided if retrospective application of the effective interest rate method is impracticable or if it is decided to measure a hybrid contract at fair value for the first time.
- Specific optional rules are established, among others:
    - Judgement on the way the company is managed for the purpose of classifying financial assets will be carried out at the **date of first application** on the basis of the facts and circumstances existing at that date. The resulting classification will be applied prospectively.
    - The carrying amount at the end of the financial year prior to that applying the changes to financial assets and liabilities that must follow the criteria:
        - for the **amortised cost**, its cost will be considered to have been amortised at the beginning of the financial year in which the new criteria are applied.
        - for the **cost or cost plus**, its cost or cost plus will be considered at the beginning of the financial year in which the new criteria are applied.

      If applicable, gains and losses that are accumulated directly in equity will be adjusted against the carrying amount of the asset.
    - At the date of the first application, a previous designation of a financial asset or financial liability may be designated or revoked in the exercise of the fair value through profits and losses option. These designations and revocations will be done on the basis of the facts and circumstances that exist at the date of initial application. The resulting classification will be applied prospectively. At the beginning of the financial year, the difference between the fair value of these financial instruments

and the carrying amount at the end of the previous financial year will be recorded in a reserve account. Equity instruments included in the **portfolio of financial assets held for sale** will be reclassified to the category of financial assets at fair value through equity, unless the company decides to include them in the category of financial assets at fair value through profits and losses, in which case the cumulative gain or loss will be accounted for in a reserve account.

  - For financial assets and financial liabilities measured at fair value for the first time, this amount will be calculated at the beginning of the financial year. Any difference from the previous year-end carrying amount will be accounted for in a reserve account or as an adjustment for a change in value if the asset is included under the category of assets at fair value through equity.

  - Comparative information will not be adjusted to the new criteria unless reclassification of items is required to show the prior year's balances adjusted to the new presentation criteria.

- Under the transitional arrangements for accounting hedges (section 6 of Recognition and Measurement Standard 9):

  - On the date of first application, companies may, in their accounting policy, choose between continuing to apply the criteria of the previous wording currently in force or those approved by this Royal Decree prospectively, provided that the requirements for this are met on the date of first application.

  - Hedging relationships that met the hedge accounting requirements under the previous wording and which also meet the requirements under the wording of this Royal Decree will be considered as continuing hedging relationships, once any new rebalancing of the hedging relationship at the time of transition has been taken into account.

  - On initial application of the hedge accounting requirements approved by this Royal Decree, the company: (i) may start applying those requirements at the same time it ceases to apply the previous hedge accounting requirements; and (ii) will treat the hedge ratio in accordance with the previous regulations as the starting point for rebalancing the hedge ratio of a continuing hedging relationship, if applicable. Any gain or loss from this rebalancing will be recognised in the profit and loss statement.

  - In exceptional cases, when the company must discontinue hedge accounting because the requirements set out in the standard are not met, the cumulative value adjustments in equity will be reclassified to a reserve account, and the carrying amount of the assets and liabilities concerned at the end of the previous year will be taken to be their carrying amount for the purposes of applying the criteria set out in Transitional Provision 1.

3. Measurement of inventories

A new section 3 is introduced in Recognition and Measurement Standard 10, "Inventories", as an exception to the general rule of measurement at cost, in line with IAS-EU 2 Inventories.

This exception consists of applying the fair value criteria minus selling costs for intermediaries that trade in listed commodities (i.e. when holding commodity inventories for trading activity), provided that "this eliminates or significantly reduces an accounting mismatch that would otherwise arise from not recognising these assets at fair value. In this case, the change in value will be recognised in the profit and loss statement."

Under the transitional arrangements, amendments will be applied retrospectively, in accordance with the provisions of Recognition and Measurement Standard 22 "Changes in accounting policies, errors and accounting estimates" of the Spanish GAAP, in the first financial year beginning on or from 1 January 2021.

4. Foreign currency transactions

The wording of Recognition and Measurement Standard 11 ("Foreign currencies") is amended to bring it into line with the new classification of financial assets at fair value.

5. Revenue recognition

Although the particularities introduced by IFRS-EU 15 have already been addressed in the interpretations published in consultations by the ICAC, this methodology of the international standard is introduced in Recognition and Measurement Standard 14 "Revenue from sales and the rendering of services", at the expense of its subsequent development in an ICAC resolution.

It therefore introduces the basic principle of recognising revenue when control of the goods (transfer of the ability to direct the full use of the asset and obtain all remaining benefits) or services (based on the degree of progress or stage of completion) undertaken with the customer is transferred and for the amount that is expected to be received from the customer, based on a sequential step-by-step process.

In addition, as a significant new feature, reporting obligations to be included in the annual report have been increased, which is a major change in comparison with the information that has been required to date. In general terms, companies must include qualitative and quantitative information on: (i) contracts with customers; (ii) judgements, and changes in those judgements, made about those contracts; and (iii) assets recognised for costs to obtain or fulfil the contract. However, the company will in each case consider the level of detail necessary to satisfy the disclosure objective and the emphasis placed on each of the different requirements.

In accordance with the transitional arrangements, changes in revenue recognition and measurement should be applied retrospectively for the first financial year starting on or after 1 January 2021, in accordance with Recognition and Measurement Standard 22 "Changes in accounting policies, errors and accounting estimates" of Spanish GAAP, using one of the two options set out in paragraphs 2 and 3 of transitional provision five. However, the practical solution should be extended to all contracts in accordance with the principle of uniformity.

6. Amendment of the Spanish GAAP for Small and Medium-Sized Businesses passed by Royal Decree 1515/2007, dated 16 November.

Following the proposals received in the public consultation procedure, it has been confirmed that the recognition and measurement criteria for financial instruments and revenue recognition in the Spanish GAAP for Small and Medium-Sized Businesses will remain unchanged, so as to maintain the policy of simplifying accounting obligations of smaller companies.

However, a number of technical improvements have been introduced with respect to: (i) fair value regulation (point 2 of section 6 of the Conceptual Accounting Framework is amended), in line with the amendment to the Spanish GAAP, although it does not include the classification of estimates by levels; (ii) criteria to account for allocating profit to the shareholder (a final paragraph is added to section 3 "Interest and dividends received from financial assets" of the Recognition and Measurement Standard 8 of "Financial Assets"), this is an amendment that also appears in the Recognition and Measurement Standard 9 of the Spanish GAAP.

7. Transitional arrangements

Transitional arrangements are introduced with respect to all the amendments introduced by Royal Decree 1/2021, as stated in previous sections, and it is provided that in the annual accounts for the first financial year starting on or after 1 January 2021:

- Comparative information will be included in the annual accounts, but will only be restated if the new criteria can be applied without hindsight bias, with certain exceptions.

  Comparative information will only be restated if all the criteria passed by this Royal Decree can be applied without hindsight bias, notwithstanding the exceptions provided for in the transitional provisions.

- Certain disclosures are to be included in the note on "Bases of presentation of annual accounts" on first application of the changes to Accounting and Measurement Standard 9 "Financial Instruments", 10 "Inventories" and 14 "Revenue from sales and the rendering of services".

For more information:

Rodrigo Ogea
rodrigo.ogea@bakermckenzie.com

Luis Canelo
luis.canelo@bakermckenzie.com

Bruno Domínguez
bruno.dominguez@bakermckenzie.com

Rubén Lago
ruben.lago@bakermckenzie.com

Baker McKenzie Madrid, S.L.P.
C/ José Ortega y Gasset, 29
Madrid 28006
España
Tel: +34 91 230 4500
Fax: +34 91 391 5149
www.bakermckenzie.com

Baker McKenzie Barcelona, S.L.P.
Av. Diagonal, 652 - Edif. D, 8th Floor
Barcelona 08034
España
Tel: +34 93 206 0820
Fax: +34 93 205 4959
www.bakermckenzie.com