**Statutory Accounting Principles (E) Working Group**

**Maintenance Agenda Submission Form**

**Form A**

## **Issue:** SSAP No. 32 – Investment Classification Project

**Check (applicable entity):**

 P/C Life Health

Modification of existing SSAP [x]  [x]  [x]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

**Description of Issue:** This agenda item has been drafted to consider *SSAP No. 32—Preferred Stock*, in accordance with the initiatives of the Investment Classification Project. This agenda item focuses on the following aspects:

1. Review existing definitions with market terms, and assess whether terms should be retained or revised.
2. Consider clarifications to existing accounting and valuation guidance based on the type of preferred stock.
3. Assess guidance for dividends and the impact of dividends on impairment assessments.
4. Clarify application of SSAP No. 32 in conjunction with SSAP No. 48 and SSAP No. 97.

**1 – Definitions**

SSAP No. 32 establishes statutory accounting principles for preferred stocks and includes preferred stocks that may or may not be publicly traded.

**Preferred Stock:**

SSAP No. 32, paragraph 3: Any class or shares of the holders of which have any preference, either as to the payment of dividends or distribution of assets on liquidation, over the holder of common stock issued by an entity.

FASB Definition: A security that has preferential rights compared to common stock.

NASDAQ Definition: A security that shows ownership in a corporation and gives the holder a claim, prior to the claim of common stockholders, on earnings and also generally on assets in the event of liquidation. Most preferred stock pays a fixed dividend that is paid prior to the common stock dividend, stated in a dollar amount or as a percentage of par value. This stock does not usually carry voting rights. Preferred stock has characteristics of both common stock and debt.

The scope of SSAP No. 32, paragraph 3, identifies that the definition of preferred stock includes:

1. Redeemable preferred stock, including mandatory sinking fund preferred stock and preferred stock redeemable by the holder;
2. Perpetual preferred stock, including nonredeemable preferred stock and preferred stock redeemable at the option of the issuer; and
3. Exchange traded funds, which qualify for preferred stock treatment, as identified in Part Six, Section 2, of the Purposes and Procedures Manual of the NAIC Investment Analysis Office.

SSAP No. 32 then includes definitions for redeemable preferred stock, perpetual preferred stock, mandatory sinking fund preferred stock, payment-in-kind preferred stock, step-up preferred stock and restricted stock.

**Redeemable Preferred Stock:**

SSAP No. 32, paragraph 4: Preferred Stock that must be redeemed by the issuing enterprise or is redeemable at the option of the reporting entity. It includes mandatory sinking fund preferred stock and payment-in-kind (PIK) preferred stock.

FASB ASC 480-10-S99 - (This guidance comes from SEC CFRR 211: Redeemable Preferred Stock): Preferred Stock Subject to Mandatory Redemption Requirements or Whose Redemption is Outside the Control of the Issuer ("Redeemable Preferred Stock"). The term means any stock which (i) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; (ii) is redeemable at the option of the holders, or (iii) has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings. Under this definition, preferred stock which meet one or more of the above criteria would be classified as redeemable preferred stock regardless of their other attributes such as voting rights, dividend rights or conversion features.

**Perpetual Preferred Stock:**

SSAP No. 32, paragraph 7: Perpetual preferred stock is defined as preferred stock with no redemption or sinking fund features or preferred stock redeemable at the option of the issuer.

FASB ASC 480-10-S99 - (This guidance comes from SEC CFRR 211: Redeemable Preferred Stock): Preferred Stocks Which Are Not Redeemable or Are Redeemable Solely at the Option of the Issuer ("Non-Redeemable Preferred Stock "). The term means any preferred stock which does not meet the criteria for classification as a "redeemable preferred stock."

*NAIC Staff Notes*:

From a review of preferred stock issuances, preferred stock may be labeled “redeemable perpetual preferred stock.” Generally, in these instances, it seems that the preferred stock is redeemable at the option of the issuer, perhaps after a certain timeframe, or when other conditions as stated in the prospectus are met. If the redemption is at the option of the issuer, these preferred stock issuances would be considered perpetual preferred stock. However, it does appear that in some instances, these issuances may be redeemable at the option of the holder after a certain timeframe. If the redemption is at the option of the holder, then it would be considered redeemable preferred stock. (Note – NAIC staff would like confirmation that preferred stock labeled as “redeemable perpetual” may meet the criteria as redeemable under FASB ASC 480-10-S99.)

Excerpts detailing a few identified instances are noted below:

*Prospectus excerpt:* We may offer and sell under this prospectus shares of our 9.375% Series A Cumulative Redeemable Perpetual Preferred Stock, $0.001 par value per share (the “Series A Preferred Stock”) having an aggregate offering price of up to $26,000,000 from time to time through the Agents. Our Series A Preferred Stock is traded on The Nasdaq Capital Market, or the Exchange, under the symbol “FBIOP.” The last reported sale price of our Series A Preferred Stock on April 4, 2018 was $22.89 per share. Dividends on our Series A Preferred Stock accrue daily and will be cumulative from, and including, the date of original issue and shall be payable quarterly every March 31, June 30, September 30, and December 31, at the rate of 9.375% per annum of its liquidation preference, which is equivalent to $2.34375 per annum per share. Generally, we may not redeem the Series A Preferred Stock until December 15, 2022. On and after December 15, 2022, we may, at our option, redeem the Series A Preferred Stock in whole, at any time, or in part, from time to time, for cash at a redemption price of $25.00 per share, plus any accrued and unpaid dividends to, but not including, the date of redemption.

*(As redemption is at the option of the issuer, the above example reflects perpetual preferred stock.)*

*Prospectus excerpt:* We are offering 204,000 shares of our 11% Series A Cumulative Redeemable Perpetual Preferred Stock, which we refer to as the Series A Preferred Stock. Dividends on the Series A Preferred Stock are cumulative from the date of original issue and will be payable on the fifteenth day of each calendar month commencing December, 2015 when, as and if declared by our board of directors. Dividends will be payable out of amounts legally available there for at a rate equal to 11% per annum per $25.00 of stated liquidation preference per share, or $2.75 per share of Series A Preferred Stock per year. We will place proceeds equal to two years of dividends into a separate bank account to be used to pay Series A Preferred Stock dividends, however, after the first quarter in which our Adjusted EBIT DA is greater than the quarterly dividend, the proceeds then remaining in this account may be used for any corporate purpose. Commencing on November 4, 2020, we may redeem, at our option, the Series A Preferred Stock, in whole or in part, at a cash redemption price of $25.00 per share, plus all accrued and unpaid dividends to, but not including, the redemption date. The Series A Preferred Stock has no stated maturity, will not be subject to any sinking fund or other mandatory redemption, and will not be convertible into or exchange able for any of our other securities. Holders of the Series A Preferred Stock generally will have no voting rights except for limited voting rights if dividends payable on the outstanding Series A Preferred Stock are in arrears for eighteen or more consecutive or non-consecutive monthly dividend periods.

*(As redemption is at the option of the issuer, the above example reflects perpetual preferred stock.)*

*Prospectus excerpt:* We are selling  shares of our  % Series B Cumulative Redeemable Perpetual Preferred Shares, par value $0.01 per share, liquidation preference $25.00 per share (the “Series B Preferred Shares”). Dividends on the Series B Preferred Shares will accrue and be cumulative from the date of original issue and will be payable quarterly in arrears on January 30, April 30, July 30 and October 30 of each year, commencing July 30, 2013, when, as and if declared by our board of directors. Dividends will be payable out of amounts legally available therefor at an initial rate equal to  % per annum of the stated liquidation preference, subject to adjustment as described in this prospectus supplement. At any time on or after July 30, 2016, the Series B Preferred Shares may be redeemed, in whole or in part, out of amounts legally available therefor, at a redemption price of $25.00 per share plus an amount equal to all accumulated and unpaid dividends thereon to the date of redemption, whether or not declared. If (i) we fail to comply with certain covenants (a “Covenant Default”), (ii) we experience certain defaults under any of our credit facilities (a “Cross Default”), (iii) four quarterly dividends payable on the Series B Preferred Shares are in arrears (a “Dividend Payment Default”) or (iv) the Series B Preferred Shares are not redeemed in whole by July 30, 2018 (a “Failure to Redeem”), the dividend rate payable on the Series B Preferred Shares shall increase, subject to an aggregate maximum rate per annum of 25% prior to July 30, 2016 and 30% thereafter, to a rate that is 1.25 times the dividend rate payable on the Series B Preferred Shares as of the close of business on the day immediately preceding the Covenant Default, Cross Default, Divided Payment Default or Failure to Redeem, as applicable, and on each subsequent Dividend Payment Date, the dividend rate payable shall increase to a rate that is 1.25 times the dividend rate payable on the Series B Preferred Shares as in effect as of the close of business on the day immediately preceding such Dividend Payment Date, until the Covenant Default, Cross Default or Dividend Payment Default is cured or the Series B Preferred Shares are no longer outstanding.

*(As redemption is at the option of the holder, the above example reflects redeemable preferred stock.)*

**Mandatory Sinking Fund:**

SSAP No. 32, paragraph 5: Mandatory sinking fund preferred stock is defined as redeemable preferred stock subject to a 100% mandatory sinking fund, annual installments of which will (a) commence not more than 10 years from the date of issue or December 31, 1978, if outstanding on that date; (b) be not less than 2% of the number of shares issued (or outstanding on December 31, 1978, if issued prior to that date); (c) provide for the redemption of the entire issue over a period not longer than 40 years from the date of issue, or December 31, 1978, if outstanding on that date. Redeemable preferred stock which is subject to a 100% mandatory sinking fund, but which does not, at date of issue or December 31, 1978, if outstanding at that time, meet one or more of the other requirements above, shall be considered as mandatory sinking fund preferred stock at the time the deficiency is cured through the passage of time or otherwise.

*(NAIC staff highlights that the reference to 1978 in this paragraph is no longer applicable as all preferred stock outstanding as of that date would have had a maximum (40-year) redemption date in 2018. In reviewing the origin of this guidance, it was identified that it has been in place since original issuance of SSAP No. 32 and it came from the Purposes and Procedures Manual of the NAIC SVO. This guidance is no longer included in the P&P Manual.)*

NASDAQ Definition “Sinking Fund”: A fund to which [money](https://www.nasdaq.com/investing/glossary/m/money) is added on a regular basis that is used to ensure [investor](https://www.nasdaq.com/investing/glossary/i/investor) confidence that promised payments will be made and that is used to [redeem](https://www.nasdaq.com/investing/glossary/r/redeemable) [debt](https://www.nasdaq.com/investing/glossary/d/debt)[securities](https://www.nasdaq.com/investing/glossary/s/security) or [preferred stock](https://www.nasdaq.com/investing/glossary/p/preferred-stock) [issues](https://www.nasdaq.com/investing/glossary/i/issue).

U.S. GAAP Glossary – Mandatorily Redeemable Financial Instrument: Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

*NAIC Staff Notes*:

NAIC staff is under the impression that the term “mandatory sinking fund preferred stock” is no longer prevalent. Rather, redeemable preferred stock with a mandatory redemption date is often referred to as “term preferred stock.” Although preferred stock may stipulate use of a sinking fund to provide assurance that preferred stock may be redeemed when due, failing to make deposits into a sinking fund as agreed by the company in the preferred stock’s provisions is not similar to an act of default on debt. Rather, such action would be subject to remedies specified in the preferred stock prospectus.

Even if preferred stock is considered to be “mandatory redeemable,” Section 160 of the Delaware General Corporation Law prohibits a corporation from redeeming its shares of capital stock when the capital of the corporation is impaired or when such redemption would cause any impairment of the capital. Under findings under this Law, it has been noted that the existence of a mandatory redemption right, even one that is ripened, does not convert the holder of preferred stock into a creditor. Specifically, a redemption right does not give the holder the absolute, unfettered ability to force the corporation to redeem its shares under any circumstances and recent case law establishes limitations on the ability of preferred stockholders to force redemption. It should be noted that preferred stock provides no guaranteed right of payment, and its redemption obligation is treated neither as debt nor as a current liability.

Under U.S. GAAP, issuers of “mandatorily redeemable financial instruments” may report the issuance as liability or as equity, depending on type of issuer. Public entities and SEC registrants are required to report mandatorily redeemable financial instruments as liabilities unless the redemption is required to occur only upon the liquidation or termination of the reporting entity (ASC 480-10-25-4). However, the guidance in *ASC 480-10: Distinguishing Liabilities from Equities* does not apply to instruments that are a) issued by nonpublic entities that are not SEC registrants and b) mandatorily redeemable, but not on fixed dates or not for amounts that either are fixed or are determined by reference to an interest rate index, currency index or another index (ASC 480-10-15-7A).

**Payment-In-Kind (PIK) Preferred Stock:**

SSAP No. 32, paragraph 6: PIK preferred stock is defined as redeemable preferred stock on which, at the option of the issuer, dividends can be paid in additional securities rather than cash.

General “in-kind” Definition: Payment-in-kind (PIK) is the use of a good or service as payment instead of cash. Payment in kind also refers to a [financial instrument](https://www.investopedia.com/terms/f/financialinstrument.asp) that pays interest or [dividends](https://www.investopedia.com/terms/d/dividend.asp) to investors of bonds, notes or [preferred stock](https://www.investopedia.com/terms/p/preferredstock.asp) with additional securities or equity instead of cash.

*NAIC Staff Notes*:

PIK stock dividends are not limited to redeemable preferred stock. Additionally, PIK provisions may not require PIK dividends to be provided in additional shares of the same preferred stock. Rather, the provisions of the preferred stock could specify that the PIK dividends are issued in other forms of preferred stock or in shares of common stock. Additionally, the preferred stock provisions can be designed to specify PIK dividends for a specific number of years, with subsequent conversion of cash dividends.

*(The existing SSAP No. 32 guidance for PIK preferred stock has been in place since original issuance of SSAP No. 32. Pursuant to Issue Paper No. 32, this information came from the “NAIC Technical Resource group Proposed Draft Life Codification.”)*

Example Prospectus Excerpt 1: Dividends on our **perpetual convertible preferred stock** will be payable on a cumulative basis when, as and if declared by our board of directors or an authorized committee of our board of directors, at an annual rate of 6.75% on the liquidation preference of $1,000 per share. We may pay declared dividends in cash or, subject to certain limitations, **in shares of our common stock**, par value $0.01 per share, or in any combination of cash and common stock on March 1, June 1, September 1 and December 1 of each year, commencing on December 1, 2015. Our perpetual convertible preferred stock has no maturity date, and we are not required to redeem our perpetual convertible preferred stock at any time. Accordingly, our perpetual convertible preferred stock will remain outstanding indefinitely unless a holder of shares of our perpetual convertible preferred stock converts it or we decide to convert or repurchase it as described herein.

Example Prospectus Excerpt 2: Each dividend shall be paid either in shares of Common Stock (“Payment-in-Kind”) or in cash, at the option of the Corporation on the respective Dividend Date; provided, however, that dividends may only be paid in cash following the fiscal year in which the Corporation has net income (as shown in its audited financial statements contained in its Annual Report on Form 10-K for such year) of at least $500,000, to the extent permitted under applicable law out of funds legally available therefor**. For Payment-in-Kind dividends, each Holder on the record date for such divided will receive that number of shares of Common Stock equal** to (i) the amount of the dividend payment due such stockholder divided by (ii) 90% of the average of the Per Share Market Values during the twenty (20) Trading Days immediately preceding a Dividend Date. No fractional shares shall be issued upon payment of such dividends pursuant to this Section 3.2 and the number of shares to be issued upon payment of such dividends will be rounded up to the nearest whole share; provided, that, in lieu of rounding up to the nearest whole share, the Corporation may, at its option, pay a cash adjustment in respect of such fractional interest equal to such fractional interest multiplied by the Per Share Market Value on the respective dividend date. Each dividend paid in cash shall be mailed to the Holders of record of the Corporation as their names appear on the share register of the Corporation or at the office of the Corporation’s transfer agent on the corresponding dividend payment date. Holders will receive written notification from the Corporation or the transfer agent if a dividend is paid in Common Stock, which notification will specify the number of shares of Common Stock paid as a dividend. Certificates representing the shares of Common Stock issuable upon payment of each Payment-In-Kind shall be delivered to each Holder entitled to receive such Payment-in-Kind (in appropriate denominations) as soon as reasonably practicable.

**Step-Up Preferred Stock:**

SSAP No. 32, paragraph 17: Step-up preferred stock (a security with the structure of a preferred stock, that has the cash flow characteristics of a debt instrument) is considered a security with characteristics of both debt and equity, and the accounting and valuation of such securities shall be consistent with SVO guidelines as stipulated in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*.

P&P Manual – There is no current guidance in the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* regarding step-up preferred stock.

General – A “step-up” feature is a component that increases over time or with stated provisions. For example, a “step-up divided” if a feature that increases the dividend rate. A “step-up call” is a feature that increases the call price for a security. A “step-up conversion” increases the conversion price in a convertible security. In review, no references were identified that limit “step-up” features to redeemable preferred stock.

The term Step-Up used with an income security means that the dividend or interest distributions will start at a lower level of income and then increase or Step-Up on a specified schedule. For example, a step-up security could start out paying a 5% dividend initially and then Step-Up to a 7% dividend after 5 years (assuming it is not called). The Step-Up or increase in the payout can occur on whatever schedule is specified in the IPO prospectus such as after 3 years, 5 years, 10 years, 15 years, etc. Currently there are only a handful of Step-Up securities on the markets.

**Restricted Preferred Stock:**

SSAP No. 32, paragraph 8: Restricted preferred stock is defined as a security for which sale is restricted by governmental or contractual requirement (other than in connection with being pledged as collateral) except where that requirement terminates within one year or if the holder has the power by contract or otherwise to cause that requirement to be met within one year. Any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted.

NASDAQ Definition – Restricted Stock**:** Stock that must be traded in compliance with special SEC regulations concerning its purchase and resale. These restrictions generally result from affiliate ownership, M&A activity, and underwriting activity. Many firms are now using restricted stock as a reward for employees. The advantages to restricted stock are: employees get dividends, employees usually get voting rights, and employee gets something even if the stock price drops over the vesting period (whereas an option would be worthless).

SEC Definition – Restricted Securities**:** "Restricted" securities are securities acquired in an unregistered, private sale from the issuing company or from an affiliate of the issuer. They typically bear a “restrictive” legend clearly stating that you may not resell them in the public marketplace unless the sale is exempt from the SEC’s registration requirements. Rule 144 under the Securities Act of 1933 provides the most commonly used exemption for holders to sell restricted securities. To take advantage of this rule, you must meet several conditions, including a six-month or one-year holding period.

*NAIC Staff Notes*:

The definition of restricted preferred stock in SSPA No. 32 is identical to the definition of common stock in SSAP No. 30. NAIC staff is researching the origin of the SSAP No. 30 and SSAP No. 32 restricted stock definition and request information regarding the source of this definition. (There is limited information in the issue paper and the definition has been in place since adoption.)

**Convertible Preferred Stock:**

SSAP No. 32: Convertible preferred stock is not currently defined in SSAP No. 32.

NASDAQ: Preferred stock that can be converted into common stock at the option of the holder.

SEC – Convertible Security: A "convertible security" is a security—usually a bond or a preferred stock—that can be converted into a different security—typically shares of the company's common stock. In most cases, the holder of the convertible determines whether and when to convert. In other cases, the company has the right to determine when the conversion occurs.

FASB Glossary – Convertible Security:A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).

*NAIC Staff Notes*:

The terms for converting preferred stock may be optional or mandatory depending on the terms of the issuance. Also, both redeemable and perpetual preferred stock can be issued with convertible features. Although there is no current guidance in SSAP No. 32, the guidance in *SSAP No. 26R—Bonds* requires specific accounting guidance for mandatory convertible bonds to prevent overstating the value of the investment prior to the mandatory conversion. NAIC staff often receives questions regarding the appropriate valuation for mandatory convertible preferred stock.

***Example - Convertible Redeemable Preferred Stock :*** WHEREAS, subject to the terms and conditions set forth in this Agreement, the Company desires to issue and sell to the Purchaser and the Purchaser desires to acquire from the Company [ ] shares of the **Company’s Series A Convertible Redeemable Preferred Stock**, (the “Series A Preferred Stock”), with a Stated Value of one dollar ($1) per share, which is part of a sale of Series A Preferred Stock with an aggregate Stated Value of $750,000.

***Example - Convertible Perpetual Preferred Stock:*** RESOLVED, that the Corporation is authorized to issue 14,375,000 shares of 6.50% **Series I Cumulative Convertible Perpetual Preferred Stock**, $1.00 par value per share, which shall have the following powers, designations, preferences and other special rights:

**Statutory Accounting Definition Overview and Assessment**

After reviewing the existing SSAP No. 32 definitions to market terms, NAIC staff recommends that the Working Group consider revisions to update SSAP No. 32 accordingly. Consideration should be given as to the extent detailed definitions of various components of preferred stock should be included, particularly if an element would not alter the accounting or reporting of a preferred stock investment. (NAIC staff highlights that other key terms of preferred stock are not currently defined in SSAP No. 32 and only the terms currently defined and/or identified as potential impacting valuation are included in the discussion.)

**2 – Clarifications to Existing Accounting and Valuation Guidance**

The valuation methods utilized for preferred stock in SSAP No. 32 depends on the type of preferred stock (redeemable or perpetual), type of insurance entity and the NAIC designation. (Although perpetual stock is more akin to equity, the NAIC designation provides a credit assessment on the dividends. For example, guidance in the P&P Manual prohibits assigning an NAIC designation of 1, 2 or 3 to any preferred stock in which dividends have not been paid or sinking fund requirements have not been met.) Pursuant to SSAP No. 32, paragraphs 19-22:

Reporting Entities that Do Not Maintain an AVR

* Redeemable with NAIC Designation 1-2: Cost or Amortized Cost
* Redeemable with NAIC Designations 3-6: Lower of Cost, Amortized Cost or Fair Value
* Perpetual with NAIC designations 1-2: Fair Value
* Perpetual with NAIC designations 3-6: Lower of Cost or Fair Value

Reporting Entities that Do Maintain and AVR

* Redeemable with NAIC Designation 1-3: Cost or Amortized Cost
* Redeemable with NAIC Designations 4-6: Lower of Cost, Amortized Cost or Fair Value
* Perpetual with NAIC designations 1-3: Cost
* Perpetual with NAIC designations 4-6: Lower of Cost or Fair Value

NAIC staff identifies that the existing guidance in SSAP No. 32 does not differentiate when a reporting entity should utilize “cost” or “amortized cost” in determining the measurement method.

The accounting under U.S. GAAP depends on whether the preferred stock is considered a debt or equity security:

**FASB Glossary - Equity Security** (First Definition)
Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:

a.  Written equity options (because they represent obligations of the writer, not investments)

b.  Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)

c.  Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

**FASB Glossary - Equity Security** (Second Definition)

Any security representing an ownership interest in an entity (for example common, preferred or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an ownership interest in an entity at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

**ASC 321-10-55-2** - If convertible preferred stock is not redeemable, it is considered an equity security and, therefore, this Topic would apply.

**FASB Glossary - Debt Security**

Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:

(a)  Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor

**Overview of U.S. GAAP Accounting:**

Under U.S. GAAP (ASC 320-10-35-1), investments in “debt securities” are reported at either fair value or amortized cost. (Debt instruments identified as “held-to-maturity” are reported at amortized cost, and debt instruments classified as “trading” or “available-for-sale” are reported at fair value.) Under U.S. GAAP, use of historical cost for investments is not generally considered an acceptable measurement method.

Under U.S. GAAP (321-10-35-1) investments in “equity securities” are reported at fair value. If an investment does not have a readily determinable fair value, the security may qualify to use net asset value as a practical expedient to fair value (820-10-35-59). If an investment does not have a “readily determinable” fair value, and does not qualify for the net asset value practical expedient, U.S. GAAP (ASC 321-10-35-2) provides guidance for determining the measurement value as follows:

* An entity may elect to measure an equity security at cost minus impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar instrument of the same issuer. An election to measure an equity security in accordance with these provisions shall be made for each investment separately. Once an entity elects to measure an equity security in accordance with this guidance, the entity shall continue to apply the measurement guidance until the investment does not qualify to be measured in accordance with this guidance (for example, if the investment has a readily determinable fair value or becomes eligible for the practical expedient to estimate fair value with 820-10-35-59). The entity shall reassess at each reporting period whether the equity investment without a readily determinable fair value qualifies to be measure with this guidance.

The U.S. GAAP fair value definition, as well as the definition for readily determinable fair value and the ability to use net asset value has been adopted for statutory accounting:

**U.S. GAAP Definition - Fair Value** *(Adopted in SSAP No. 100R, paragraph 4.)***:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**U.S. GAAP Definition - Readily Determinable Fair Value** *(Adopted in SSAP No. 100R, paragraph 41*): An equity security has a readily determinable fair value if it meets any of the following conditions:

a.   The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.

b.   The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.

c.   The fair value of an equity security that is an investment in a mutual fund or in a structure similar to a mutual fund (that is, a limited partnership or a venture capital entity) is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

**U.S. GAAP Guidance permitting NAV** *(Adopted with modification in SSAP No. 101, paragraphs 39-46):*Limited Excerpt**:** A reporting entity is permitted, as a practical expedient, to estimate the fair value of an investment within the scope of paragraphs 820-10-15-4 through 15-5 using the net asset value per share (or its equivalent, such as member units or an ownership interest in partners’ capital to which a proportionate share of net assets is attributed) of the investment, if the net asset value per share of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity’s measurement date.

**Statutory Accounting Measurement Overview and Assessment**

After reviewing the measurement methods for preferred stock, and comparing those methods to U.S. GAAP, NAIC staff recommends revisions to the permitted measurement methods for preferred stock. NAIC staff recommends eliminating references to “cost” as a measurement option, and clarify use of amortized cost (or the lower of amortized cost and fair value) for redeemable preferred stock and the use of fair value for perpetual preferred stock.

If there are concerns that perpetual preferred stock could not be measured at fair value (either as not readily determinable or with a NAV exception), consideration could be given to incorporate the FASB process that allows “adjusted cost”. However, NAIC staff believes that in most instances, fair value of perpetual preferred stock can be determined pursuant to SSAP No. 100R, even if that determination reflects a level 3 fair value measurement. (Under level 3, the reporting entity determines fair value without observable inputs using their assumptions about the assumptions market participants would use in pricing the asset or liability.)

**3 – Assess Dividend Guidance and the Impact of Dividends on Impairment Guidance**

Existing guidance in SSAP No. 32, paragraph 27, identifies that dividends, other than mandatorily redeemable preferred stock, shall be recorded as investment income on the ex-dividend date. The guidance in paragraph 28 identifies that mandatorily preferred stock shall be accrued to the redemption price, even if not declared, under the interest method over the period ending on the redemption date. The guidance also identifies that cash dividends paid on payment-in-kind (PIK) dividends shall be accounted for as a reduction in the investment.

Impairment guidance in SSAP No. 32 differentiates between redeemable and perpetual preferred stock. The guidance for redeemable preferred stock is similar to guidance for bonds, in which other-than-temporary impairment (OTTI) is considered to have occurred if a reporting entity will be unable to collect all amounts due according to the contractual terms of the security at the date of acquisition. This determination includes situations when a decision has been made to sell a security below its carrying value. The guidance for perpetual preferred stock is similar to guidance for common stock, with determination of OTTI based on *INT 06-07: Definition of Phrase “Other Than Temporary*” and if the entity has made a decision to sell a security below its carrying value.

Although NAIC staff believes the guidance for perpetual preferred stock dividends is appropriate, recognizing that dividends for redeemable preferred stock may not trigger an element a default, or a liability from an issuing entity, NAIC staff recommends clarification on the amortization of redeemable preferred dividends, potentially to highlight that failure to receive dividends should result with an OTTI assessment and may impact continued accrual (or admittance) for future dividends.

With regards to guidance on PIK dividends, NAIC staff recommends revisions to address recognition and reporting of differing types of PIK dividends. As noted, stock issuances may provide for either cash or PIK dividends, and it is likely not appropriate to require all cash dividends for these issuances to be recorded as a reduction in the investment. (With these revisions, NAIC staff also recommends similar guidance for PIK interest received.)

**4 – Clarify application of SSAP No. 32 conjunction with SSAP No. 48 and SSAP No. 97**

The existing guidance in SSAP No. 32 is specific that investments in preferred stock of subsidiaries, controlled or affiliated entities (SCA) are included within scope. However, recent questions received have questioned whether preferred stock held from a SSAP No. 48 entity shall be captured within scope of SSAP No. 32. (A SSAP No. 48 entity may or may not qualify as an SCA.) To eliminate future questions, NAIC staff suggests further clarification that preferred stock held from a SSAP No. 48 entity (joint venture, partnership or limited liability company) is in scope of SSAP No. 32.

Additionally, as the reported value of preferred stock held from an SCA may be impacted by guidance in *SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities* and *INT 00-24: EITF 98-12: Accounting by an Equity Method Investor for Investee Losses When the Investor Has Loans to and Investments in Other Securities of the Investee and EITF 99-10: Percentage Used to Determine the Amount of Equity Method Losses,* NAIC staff suggests guidance in SSAP No. 32 that explicitly refers to those statutory provisions.

* Under SSAP No. 97, preferred stock in an SCA is measured and reported under SSAP No. 32. However, the reporting entity must reduce the total equity of the SCA by the SCA’s (issuer’s) value of the preferred stock to prevent double counting. For example, if an SCA issued preferred stock for $50,000, and the SCA value is $250,000 pursuant to SSAP No 97:
	+ Reporting entity would report the SCA at $200,000. ($250,000 less $50,000)
	+ Reporting entity would report the preferred stock under SSAP No. 32. (So, if perpetual preferred stock, issued at $50,000, has a current fair value was $75,000, the preferred stock would be reported at $75,000 on Schedule D-2-1.)
* Under INT 00-24, once an equity (common stock) investment in an SCA has been reduced to zero due to losses in the investee, the investor shall report its share of equity method losses as an adjustment to the other investments in the investee. Pursuant to this guidance, the reported investment in preferred stock (and other investments in an SCA) would be adjusted to reflect the statutory net loss. *(NAIC staff notes – This guidance is reflected in the FASB Codification in ASC 323-10-35 regarding equity method losses.)*

**Existing Authoritative Literature:**

*SSAP No. 32—Preferred Stock*  provides the statutory accounting principles for preferred stock.

## **Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups):** A review of the investment SSAPs, including SSAP No. 32, was supported under the investment classification project detailed in agenda item 2013-36. Currently, the Working Group has reviewed and adopted revisions to *SSAP No. 26R—Bonds* and *SSAP No. 30R—Common Stock*.

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group:** None.

Staff Recommendation:

NAIC staff recommends that the Working Group move this item to the active listing, categorized as substantive, with a request to expose the agenda item for comments on suggested actions / proposals. With this exposure, NAIC staff recommends a referral to the Valuation of Securities (E) Task Force with a request for information on preferred stock and the suggested actions. After information is received and assessed, NAIC staff will proceed with drafting revisions to SSAP No. 32, along with a corresponding issue paper, for subsequent exposure.

NAIC staff recommended actions:

1. Definitions:
2. Retain, with revisions to mirror FASB terminology, the definitions for redeemable and perpetual preferred stock. These definitions will be used to classify preferred stock for valuation and reporting purposes. With this action, the definition for restricted preferred stock is also proposed to be retained in the SSAP, with revisions to properly capture the intent of this definition with current market terms.
3. Delete existing definitions for mandatory sinking fund preferred stock, payment-in-kind (PIK) preferred stock and step-up preferred stock. If preferred, revised terms to identify various elements of preferred stock may be considered for inclusion in a SSAP No. 32 glossary, but as these terms do not impact valuation or reporting, NAIC staff proposes to eliminate these terms from the SSAP. If terms are retained in a glossary, it is proposed that they be revised to reflect current market terminology. If terms will be retained, NAIC staff requests comments on additional terms that should be captured.
4. Incorporate new guidance to define, and provide accounting guidance for mandatory convertible preferred stock. This guidance is proposed to mirror the mandatory convertible guidance in *SSAP No. 26R—Bonds*. With that approach, the reported value shall be equal to, or less than, the valuation that will be required upon mandatory conversion. (For example, if redeemable preferred stock is mandatorily convertible to common stock, the value shall be the lower of amortized cost or fair value.)
5. Accounting and Valuation Guidance:
6. Delete all references to “cost” as a measurement method. Redeemable preferred stock shall be reported at amortized cost, or the lower of amortized cost or fair value depending on NAIC designation. (It is proposed that the existing NAIC designations allocations will be retained.) Perpetual preferred stock shall be reported at fair value.
7. Incorporate new guidance to account for mandatory convertible redeemable preferred stock. Similar to the guidance for mandatory convertible bonds, this is proposed to reflect the lower of amortized cost or fair value without impact by an NAIC designation.
8. Dividend Guidance and the Impact on Impairment Guidance
9. Incorporate revisions to clarify the reporting of PIK dividends and PIK interest. This guidance is proposed to direct recognition of dividends and interest pursuant to the nature of the item received. (For example, common stock dividends would be captured under SSAP No. 30.) A reduction of investment would only occur if consideration received was intended to reduce the preferred stock investment.
10. Clarify OTTI assessment when dividends for redeemable preferred stock are not received, or when other redemption protections (e.g., sinking fund deposits) are not met by an issuer.
11. Clarify application of SSAP No. 32 in conjunction with SSAP No. 48 and SSAP No. 97
12. Clarify that preferred stock held issued by a SSAP No. 48 entity is in scope of SSAP No. 32.
13. Incorporate guidance / references to clarify the measurement and reporting of preferred stock held from an SCA pursuant to guidance in SSAP No. 97 and INT 00-24. As detailed, INT 00-24 requires a reduction in a preferred stock investment of an SCA once the equity basis of a common stock investment reaches zero.

Staff Review Completed by: Julie Gann – February 2019

Status:

On April 6, 2019, the Statutory Accounting Principles (E) Working Group moved this item to the active listing, categorized as substantive, and directed NAIC staff to draft revisions to SSAP No. 32 for subsequent exposure. A referral to the Valuation of Securities (E) Task Force to review the proposed edits will occur when exposed.

On August 3, 2019, the Statutory Accounting Principles (E) Working Group exposed *Issue Paper No. 1XX—Preferred Stock* to revise the definitions, measurement guidance and impairment guidance for preferred stock pursuant to the investment classification project.

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