

## **Statutory Issue Paper No. 30**

### **Investments in Common Stock (excluding investments in common stock of subsidiary, controlled, or affiliated entities)**

#### **STATUS**

**Finalized March 16, 1998**

**Original SSAP and Current Authoritative Guidance: SSAP No. 30**

#### **Type of Issue:**

**Common Area**

#### **SUMMARY OF ISSUE**

1. Current statutory guidance pertaining to the valuation of and accounting for common stock is contained in the Accounting Practices and Procedures Manuals for Life and Accident and Health and for Property and Casualty Insurance Companies. That guidance also established the NAIC's Securities Valuation Office (SVO) as the primary authority for the valuation of common stocks. The purpose of this issue paper is to establish statutory accounting principles for common stocks, including those loaned under a securities lending agreement, which are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts).
2. Accounting for investments in common stock of subsidiaries, controlled or affiliated entities (investments in affiliates) will be addressed in a separate issue paper.

#### **SUMMARY CONCLUSION**

3. For purposes of statutory accounting, common stocks (excluding investments in affiliates) are securities which represent a residual ownership in a corporation and shall include:
  - a. Publicly traded common stocks.
  - b. Master limited partnerships trading as common stock and American deposit receipts only if the security is traded on the New York, American, or NASDAQ exchanges.
  - c. Publicly traded common stock warrants.
  - d. Shares of mutual funds, except for certain money market funds and Class 1 Bond Funds as designated in the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, regardless of the types or mix securities owned by the fund (e.g., bonds, stock, money market instruments, or other type of investments).
  - e. Common stocks that are not publicly traded.
  - f. Common stocks that are restricted as to transfer of ownership. Restricted stock shall be 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 the 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.

4. Common stocks meet the definition of assets as defined in *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets* and are admitted assets to the extent they conform to the requirements of this paper.

5. Common stock acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

6. Dividends on common stock shall be recorded as investment income on the ex-dividend date with a corresponding receivable to be extinguished upon receipt of cash (i.e., dividend income shall be recorded on stocks declared to be ex-dividends on or prior to the statement date). For reporting entities required to maintain an Asset Valuation Reserve (AVR), the accounting for realized capital gains and losses on sales of common stock shall be in accordance with *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve* (Issue Paper No. 7). For reporting entities not required to maintain an AVR, realized gains and losses on sales of common stock shall be reported as realized gains/losses in the statement of operations.

7. At acquisition, common stocks shall be reported at their cost, including brokerage and other related fees. At each reporting date, investments in common stocks shall be valued and reported in accordance with the *Purposes and Procedures Manual of the NAIC Securities Valuation Office*. In those instances where fair market value is not available from the SVO, it is the responsibility of management to determine market value based on analytical or pricing mechanisms. For reporting entities required to maintain an AVR, the accounting for unrealized capital gains and losses shall be in accordance with Issue Paper No. 7. For reporting entities not required to maintain an AVR, unrealized capital gains and losses shall be recorded as a direct credit or charge to surplus.

8. For any decline in the fair value of a common stock which is determined to be other than temporary, the common stock shall be written down to fair value as the new cost basis and the amount of the write down shall be accounted for as a realized loss. For those reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with Issue Paper No. 7. Subsequent fluctuations in market value shall be recorded as unrealized gains or losses. Future declines in market value which are determined to be other than temporary, shall be recorded as realized losses. A decline in fair value which is other than temporary includes situations where a reporting entity has made a decision to sell a security at an amount below its carrying value (association value). This is consistent with *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*.

9. An investor can subscribe for the purchase of stock, but not be required to make payment until a later time. Transactions of this nature are common in the formation of corporations. Common stock acquired under a subscription represents a conditional transaction in a security authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual security is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Common stock acquired under a subscription shall be recorded as an admitted asset when the reporting entity or its designated custodian or transfer agent takes delivery of the security and the security is recorded in the name of the reporting entity or its nominee (i.e., the accounting for such common stock acquisitions shall be on the settlement date).

### **Loaned Stock**

10. When stocks are loaned, they remain assets of the reporting entity and are not removed from the accounting records as the reporting entity remains the owner of the stocks. When collateral is provided for the general use of the reporting entity, the asset is recorded and the admissibility of the asset is determined as if the reporting entity owned the collateral asset. A liability for the return of that collateral must be established. When collateral not available for the general use of the reporting entity is provided, it should not be recognized as an asset of the reporting entity. When non-cash collateral is provided, the

current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

### **Stock Splits, Stock Dividends, Payment in Kind Dividends, and Stock Exchanges**

11. Stock splits, stock dividends, payment in kind dividends and stock exchanges shall be accounted for in accordance with *Issue Paper No. 73—Nonmonetary Transactions*.

### **Disclosures**

12. The following disclosures shall be made for common stocks in the notes to the financial statements.

- a. Basis at which the common stocks are stated.
- b. If the reporting entity has entered into securities lending transactions, its policy for requiring collateral, a description of any loaned common stocks, including the amount, description of the collateral and whether or not the collateral is restricted.
- c. A description, as well as the amount, of common stock that is restricted and the nature of the restriction.

### **DISCUSSION**

13. The statutory accounting principles described in paragraphs 3-7 and in paragraph 10 above are consistent with current statutory accounting guidance for common stocks. This issue paper rejects the accounting principles set forth in *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* (FAS 115). The statutory accounting principles described above add additional conservatism to existing statutory guidance by adopting the concept of other than temporary declines and requiring those be charged to realized losses (paragraph 8) and requiring that certain common stock transactions not be recorded until settlement date (paragraph 9).

14. This issue paper adopts paragraphs 9-12, 15, 17, 23-31 and 61-65 of *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125) as they relate to common stock. The guidance on loaned securities in this issue paper is drafted under the general rule that securities lending transactions do not meet the criteria for surrender of control necessary to classify the transaction as a sale. If the criteria in paragraph 9 of FAS 125 regarding surrender of control are met, the transaction shall be accounted for by the transferor as a sale of the “loaned” securities.

15. Paragraph 14 of FAS 125 is rejected as it relates to the classifications of securities under FAS 115. FAS 115 was rejected in *Issue Paper No. 26—Bonds, excluding Loan-Backed and Structured Securities*.

16. The statutory accounting principles outlined in the conclusion above are consistent with the concept of recognition in the Statement of Concepts. Pertinent excerpts follow:

#### **Recognition**

The ability to meet policyholder obligations is predicated on the existence of readily marketable assets available when both current and future obligations are due. Assets having economic value other than those which can be used to fulfill policyholder obligations, or those assets which are unavailable due to encumbrances or other third party interests should not be recognized on the balance sheet but rather should be charged against surplus when acquired or when availability becomes questionable.

**Drafting Notes/Comments**

- Accounting for common stock holdings of subsidiary, controlled and affiliated entities is addressed in *Issue Paper No. 46—Accounting for Investments in Subsidiary, Controlled and Affiliated Entities*.
- Investment income due and accrued is addressed in *Issue Paper No. 34—Investment Income Due and Accrued*.
- Accounting for the Asset Valuation Reserve (AVR) equity component required for common stock holdings will be addressed in *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*.
- Securities not yet valued by the SVO will follow SVO procedures for valuing such securities as being drafted by the SVO as directed by the Invested Asset Working Group of the Valuation of Securities (EX4) Task Force.

**RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE****Statutory Accounting**

17. The Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies provides guidance with respect to common stock (similar guidance is also in the Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies). Pertinent excerpts are as follows:

Shares of capital stock represent units of ownership in a corporation, including common and preferred stock, mutual fund shares, transferable savings and loan association shares, warrants, and options to purchase stock. A return on stock held for investment is generally in the form of cash dividends which are paid to the owner. Occasionally, dividends are paid in the form of additional shares of stock. Liquidation of stock investments may give rise to capital gains or losses. (Investment in stock of parents, subsidiaries or affiliates is discussed in Chapter 6.)

Common stockholders are the residual owners of the corporation and assume the ultimate risk associated with ownership up to the limit of their investment. They are usually entitled to voting powers of ownership. At liquidation, their claim to assets is after those of creditors and preferred stockholders. Common stockholders may liquidate their ownership rights in a corporation by selling their shares in the secondary market.

**Valuation**

Common and preferred stocks are generally required to be reported at the value published in the Valuations of Securities manual published by the NAICs Valuation of Securities Task Force at the end of each year. This value is the subcommittee's determination of "market" for each listed stock.

The valuation of stock purchase warrants, stock purchase options that may be exercised on December 31 of the year for which the annual statement is being prepared, loaned securities, and investments in subsidiaries shall be in accordance with the practices and procedures prescribed by the NAIC and the state of domicile.

Securities not listed in the manual, securities listed with no value because insufficient information for valuation was submitted to the Valuation of Securities Task Force, and restricted stock require the determination of an acceptable value. Insurance companies are required to submit sufficient information on these securities to the NAIC Securities Valuation Office to permit them to determine market value.

## Dividends

Dividends are usually recorded in the general ledger on a cash basis. Dividends receivable on qualified shares of stock are generally permitted as admitted assets to the extent that the dividend has been excluded from the determination of the market price of the holding (i.e., on stock selling ex-dividend). Dividends receivable are included in "Investment Income Due and Accrued" in the annual statement. The asset is developed by a determination of the dividend status of each stock investment at the balance sheet date. Thus, dividend income on stock for any period consists of dividends collected during the year and the change in the declared but unpaid dividends between the beginning and end of the period.

The *Valuations of Securities* manual has a complete listing of all stocks that are traded "ex-dividend" at the end of the year. An ex-dividend stock is one in which the issuing company has closed its stock ledger on a certain date and has declared a dividend payable to the stockholder of record, even though the stock may have been sold after the record date but prior to the payment date. The association value of ex-dividend stock includes no value for the dividend since the unpaid dividend does not transfer with ownership of the stock. The listing of ex-dividend stock contains the declared dividend rate for calculating the declared but unpaid dividends that are allowable for each stock owned by the company on the dividend record date.

## Loaned Stock

Where the law or regulation of the insurer's state of domicile does not prohibit such activity, stock may be loaned to authorized securities broker/dealer or to authorized financial institutions.

Securities lending is conducted through open-ended agreements, which may be terminated on short notice by the lender or borrower. Securities loans are collateralized by cash and/or cash equivalents, and securities issued by the U.S. Government or its agencies. Securities lending transactions may be negotiated directly between an insurer and a borrower, or indirectly through an insurer's custodian/agent and a borrower.

When stocks are loaned, they remain assets of the insurance company and are not removed from the accounting records as the insurance company remains the owner of the stocks. When cash collateral is provided and it is deposited for the general use of the company, it becomes an asset of the company, and a liability for the return of that collateral must be established.

When non-cash collateral not available for the general use of the company is provided, it should not be recognized as an asset of the company. If balance sheet accounts are used for non-cash collateral control purposes, a contra account should be used to neutralize or zero out the balance sheet account so that no net asset value is reported in the assets of the insurance company. When non-cash collateral is used, current market value of that collateral must be used to determine adequacy of the collateral held relative to the current market value of the loaned stocks/securities.

As stated in the NAIC *Valuations of Securities* manual, the minimum collateral on securities loaned is 102% of the market value of loaned stocks. The value of collateral will at times exceed or go below 102% of the market value of securities loaned due to daily market fluctuations in both the stocks loaned and collateral. A daily "mark to market" or valuation procedure must be in place to ensure that the market value of the collateral never goes below 100% of the market value of securities loaned and that calls for additional collateral to maintain the 102% minimum which should be made on a timely basis.

If the collateral on stocks is denominated in a different currency than the stocks being loaned, the minimum collateral on these securities loaned is 105% of the market value of loaned stocks as noted in the NAIC *Valuations of Securities* manual. Again, the same daily valuation procedures noted above must be in place to ensure adequate collateral for stocks loaned.

The valuation of the stocks remain unaffected by the loan as long as the amount of collateral is at least equal to the minimum amounts specified above. Failure to hold sufficient collateral may result in the admitted assets value being decreased by the amount of insufficient collateral.

18. The *Purposes and Procedures Manual of the NAIC Securities Valuation Office - Section 5 - Procedures for Valuing Common Stocks and Stock Warrants* contains the following guidance:

(A) Common Stocks of Companies Not Classified as Being Subsidiaries, Controlled or Affiliated, Under Section 5(B).

(a) Association values for publicly traded common stocks and warrants, including, where permitted by law or regulation of an insurer's state of domicile, shares against which exchange traded call options are outstanding, and where the requirements of Section 5(C)(1) are met, shall be equal to market value at date of statement, excepting that, where permitted by law or regulation of an insurer's state of domicile, shares loaned to others shall be valued at the market value at date of statement if the Acceptable Collateral, as hereinafter defined, is pledged as security for the loan and except as set forth in the following sentence, the Acceptable Collateral pledged as security is, at the inception of the loan, in an amount equal to 102% of the market value of the loaned shares. In event that foreign shares are the subject of the loan and the denomination of the currency of the Acceptable Collateral is other than the denomination of the currency of the loaned foreign shares, the amount of Acceptable Collateral which shall be pledged shall be an amount equal to 105% of the market value of the loaned shares. A decline in value of the Acceptable Collateral or an increase in the value of the loaned shares during the term of the loan shall not result in disqualification from valuation in accordance with the above if, during the term the loan is outstanding, additional Acceptable Collateral is posted any time the amount of Acceptable Collateral declines to 100% of the market value of the loaned shares (or 102% of the market value of the loaned shares if Acceptable Collateral in an amount equal to 105% was required to be posted at the inception of the loan) in an amount equal to the difference between the 102% or 105% initially required to be posted and 100% or 102%, respectively. For purpose of this provision, Acceptable Collateral shall mean cash and cash equivalents and shall include securities issued by the U.S. Government or its agencies. Any shortfall in the amount of the actual Acceptable Collateral posted and the required 102% or 105%, as applicable, shall be deducted from the otherwise determined statement value.

Shares of mutual funds, except for certain money market funds as defined by 17 CFR 270.2a-7 under the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) and further defined in section 5(A)(a)(i) and 5(A)(ii), regardless of the types or mix of securities owned (bonds, stock, money market instruments, or other type of investments) by the fund, are considered to be common shares which should be reported on Schedule D-Part 2-Section 2.

(i) A money market fund shall not require a reserve if the fund meets all of the following conditions:

- (1) The fund shall maintain a money market fund rating in the highest category from an SVO recognized rating agency; and
- (2) The fund shall maintain a constant net asset value per share at all times; and
- (3) The Fund shall allow a maximum of seven day redemption of proceeds; and

- (4)
      - (a) The fund shall invest 100% of its total assets in U.S. treasury bills, notes, and bonds and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(F) for a list of qualifying Funds), or
      - (b) The fund shall invest 100% of its total assets in certain securities listed in Section 6(B)(g)(i) and collateralized repurchase agreements comprised of those obligations at all times (see Section 5(G) for a list of qualifying Funds).
  - (ii) A money market fund shall establish a reserve using the bond class one reserve factor if the fund meets all of the following conditions:
    - (1) The fund shall invest at least 95% of its total assets in exempt securities listed in Section 6A(a), short-term debt instruments with a maturity of 397 days or less, class one bonds, and collateralized repurchase agreements comprised of those securities at all times (see Section 5(H) for a list of qualifying Funds): and
    - (2) The fund shall maintain a money market fund rating in the highest category by an SVO approved rating agency: and
    - (3) The fund shall maintain a constant net asset value per share at all times: and
    - (4) The fund shall allow a maximum of seven day redemption of proceeds:
  - (iii) A money market fund which qualifies for reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii) shall be reported on Schedule DA-Part 1.
  - (iv) In order to qualify for a reserve exemption pursuant to Section 5(A)(a)(i) or inclusion in the bond class one reserve category pursuant to Section 5(A)(a)(ii), a money market fund shall submit documentation on forms provided by the SVO staff. The forms shall include sufficient information to demonstrate compliance with the above requirements.
  - (v) In order to maintain the qualifications for exemption or inclusion in the bond class one reserve category, the fund shall report annually, current fund information to the SVO staff by November 15. In addition, the fund shall report to the SVO any change in investment policy which requires notice to shareholders.
- (b) Association Values for common stocks which are not publicly traded, other than those issued by insurance companies (for which see Section (c) hereunder), shall be determined by the SVO Staff.
  - (c) Association Values for common stocks which are not publicly traded which are issued by insurance companies will be equal to book value, which shall be calculated as follows: by dividing the amount of its capital and surplus as shown in its last annual statement or subsequent report of examination (excluding from surplus, reserves required by statute and any portion of surplus properly allocable to policyholders, rather than stockholders) less the value (par or redemption value, whichever is the greater) of all of its preferred stock, if any,

outstanding, by the number of shares of its common stock issued and outstanding.

- (d) The foregoing provisions shall in all cases be subject to the procedures prescribed by state insurance department practices or laws concerning the use of acquisition cost or any other basis for the valuation of stocks of insurance companies.
- (B) Common Stocks of Subsidiary, Controlled or Affiliated Companies (*section not included as not relevant to this issue paper*)
- (C) Stock Warrants.
  - (1) Stock Warrants.

All warrants which are exercisable on the date of the Statement shall be valued at Association Value as defined below whether or not physically attached to any other security (See (D), hereunder, for the valuation of warrants exercisable into securities which are restricted as to transferability.)

- (a) For publicly traded warrants (other than exchange traded) the Association Value shall be equal to market value.
  - (b) The Association Value for a warrant having no public market which is currently exercisable into shares of common stock which have no public market shall be the difference resulting from the subtraction from the analytically determined Association Value of the stock of the exercise price for the warrant.
  - (c) The Association Value for a warrant having no public market which is currently exercisable into shares of common stock which have a counterpart public market but which are themselves restricted shall be the difference resulting from the subtraction from the value of the common shares as determined under the procedures of Section 5(D) below of the exercise price for the warrant.
  - (d) Warrants having no public market and for which the first exercise date is subsequent to the date of the statement shall have no value for statement purposes.
- (D) Common Stocks Having a Public Market Which Are Issued Under an Investment Letter or Are Otherwise Restricted as to Transferability.

Restricted common stocks (which for purposes of this section, are defined as restricted shares of an unaffiliated issuer held for a period of less than three years prior to the date of valuation) shall be valued by insurers in their Annual Statements on a basis which they are prepared to justify to the SVO staff. (Restrictions shall be considered to have expired for common stocks held at least three years prior to the date of valuation, and the regular valuation basis shall apply.) Such values shall be reviewed by the SVO staff as to the reasonableness of the valuation basis used. The results of the SVO staff's review will be made available to insurance departments and upon request to insurers holding said restricted common stocks.

Warrants exercisable into such restricted common stocks will be valued on the same special basis.

All restricted common stocks and warrants exercisable into the same should be appropriately noted in the Annual Statement, as required, in Schedule D- Part 2- Section 2.



Market values, where used in the determination of Association Values carried in the SVO manual, are not intended for use in valuing restricted common stocks, warrants as described in this section. Values for such restricted common stocks, warrants will not be carried in the SVO publication.

(E) Exceptions.

Where required by special conditions the foregoing standards may be varied by the Task Force.

(F) Money Market Funds Filed With The SVO Which Qualify Under Section 5(A)(a)(i)(4)(a)

(listing not included for purposes of this issue paper)

19. Several states have statutes that address valuation of common stocks not listed in the Valuations of Securities manual. In addition, one state clarifies the definition of common stock. See excerpts below:

- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311:

As used in this section the term "common stock" includes transferable certificates of participation in business trusts.

- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116-- Valuation of Assets

6. Common Stocks.

a. Common stocks are to be valued at market value. Market value as used for valuation of common stocks means in accordance with the values listed in "Valuation of Securities." For securities which are traded on a registered national securities exchange, but are not listed in that publication, market value may be established at the most recent published trade value. Securities not listed in and not actively traded on a registered national securities exchange shall have a market value in an amount that the insurer can justify to the commissioner.

- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments

(A)(1) Investments, shall be valued in accordance with the published valuation standards of the National Association of Insurance Commissioners. Securities investments as to which the National Association of Insurance Commissioners has not published valuation standards in its Valuation of Securities Manual or its successor publication shall be valued as follows:

(a) All obligations having a fixed term and rate shall, if not in default as to principal and interest, be valued as follows: (i) if purchased at par, at par value; (ii) if purchased above or below par, on the basis of the purchase price adjusted so as to bring the value to par at maturity and so as to yield in the meantime the effective rate of interest at which the purchase was made; or in lieu of such method, according to such accepted method of valuation as is approved by the commissioner, but no such method shall be inconsistent with valuation methods used by insurers in general, or any method currently formulated or approved by the National Association of Insurance Commissioners.

- (b) Purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase, plus actual brokerage, transfer, postage or express charges paid in the acquisition of such securities.
  - (c) Common, preferred or guaranteed stocks shall be valued at their market value or at the option of the company, they may be valued at purchase price if purchase price is less than market value.
- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation
    - (1) Securities, other than those referred to in §§ 625.141, held by an insurer shall be valued, in the discretion of the department, at their market value, or at their appraised value, or at prices determined by it as representing their fair market value.
  - Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values
    - (1) Each insurer reporting stocks and bonds as admitted assets in its annual statement shall be responsible for establishing a value for such securities. Except as otherwise provided by law, the procedures for establishing such values where applicable shall be as follows:
      - (a) Other than the nonadmissible exceptions listed in paragraph (2) of this Rule, values must comply with the rules for valuation contained in the National Association of Insurance Commissioners' Valuation of Securities Task Force publication, Valuations of Securities, for the applicable year.
      - (b) Securities not listed in the National Association of Insurance Commissioners' Committee on Valuation of Securities publication Valuation of Securities shall have no value, unless, upon application to such Committee on Valuation of Securities and submission of all relevant material required by the committee, and such committee establishes a value for the securities.

### Generally Accepted Accounting Principles

20. FAS 115, paragraph 12, provides the following guidance with respect to common stocks:

Investments in debt securities that are not classified as held-to-maturity and equity securities that have readily determinable fair values shall be classified in one of the following categories and measured at fair value in the statement of financial position:

- a. Trading securities. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) shall be classified as trading securities. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price. (Note: remainder of paragraph not reproduced as not applicable to equity securities)
  - b. Available-for-sale securities. Investments not classified as trading securities (nor as held-to-maturity securities) shall be classified as available-for-sale securities.
21. Paragraph 13 of FAS 115 discusses reporting changes in fair value and states the following:

Unrealized holding gains and losses for trading securities shall be included in earnings. Unrealized holding gains and losses for available-for-sale securities (including those classified as current assets) shall be excluded from earnings and reported as a net amount in a separate component of shareholders' equity until realized. Paragraph 36 of FASB Statement No. 109,

Accounting for Income Taxes, provides guidance on reporting the tax effects of unrealized holding gains and losses reported in a separate component of shareholders' equity.

22. Paragraph 14 of FAS 115 discusses income recognition and states the following:

Dividend and interest income, including amortization of the premium and discount arising at acquisition, for all three categories of investments in securities shall continue to be included in earnings. This Statement does not affect the methods used for recognizing and measuring the amount of dividend and interest income. Realized gains and losses for securities classified as either available-for-sale or held-to-maturity also shall continue to be reported in earnings.

23. Paragraph 16 of FAS 115 discusses impairment of securities and states the following:

For individual securities classified as either available-for-sale or held-to-maturity, an enterprise shall determine whether a decline in fair value below the amortized cost basis is other than temporary. For example, if it is probable that the investor will be unable to collect all amounts due accounting to the contractual terms of a debt security not impaired at acquisition, an other-than-temporary impairment shall be considered to have occurred.<sup>4</sup> If the decline in the fair value is judged to be other than temporary, the cost basis of the individual security shall be written down to fair value as a new cost basis and the amount of the write-down shall be included in earnings (that is, accounted for as a realized loss). The new cost basis shall not be changed for subsequent recoveries in fair value. Subsequent increases in the fair value of available-for-sale securities shall be included in the separate component of equity pursuant to paragraph 13; subsequent decreases in fair value, if not an other-than-temporary impairment, also shall be included in the separate component of equity.

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<sup>4</sup> A decline in the value of a security that is other than temporary is also discussed in AICPA Auditing Interpretation, Evidential Matter for the Carrying Amount of Marketable Securities, which was issued in 1975 and incorporated in Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures, as Interpretation 20, and in SEC Staff Accounting Bulletin No. 59, *Accounting for Noncurrent Marketable Equity Securities*.

24. FAS 125 provides the following guidance:

Accounting for Transfers and Servicing of Financial Assets

9. A transfer of financial assets (or all or a portion of a financial asset) in which the transferor surrenders control over those financial assets shall be accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

- a. The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership (paragraphs 23 and 24).
- b. Either (1) each transferee obtains the right—free of conditions that constrain it from taking advantage of that right (paragraph 25)—to pledge or exchange the transferred assets or (2) the transferee is a qualifying special-purpose entity (paragraph 26) and the holders of beneficial interests in that entity have the right—free of conditions that constrain them from taking advantage of that right (paragraph 25)—to pledge or exchange those interests.
- c. The transferor does not maintain effective control over the transferred assets through (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 27-29) or (2) an agreement that entitles the transferor to repurchase or redeem transferred assets that are not readily obtainable (paragraph 30).

10. Upon completion of any transfer of financial assets, the transferor shall:
- a. Continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 35-41), beneficial interests in assets transferred to a qualifying special-purpose entity in a securitization (paragraphs 47-58), and retained undivided interests (paragraph 33)
  - b. Allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 31-34).
11. Upon completion<sup>3</sup> of a transfer of assets that satisfies the conditions to be accounted for as a sale (paragraph 9), the transferor (seller) shall:
- a. Derecognize all assets sold
  - b. Recognize all assets obtained and liabilities incurred in consideration as proceeds of the sale, including cash, put or call options held or written (for example, guarantee or recourse obligations), forward commitments (for example, commitments to deliver additional receivables during the revolving periods of some securitizations), swaps (for example, provisions that convert interest rates from fixed to variable), and servicing liabilities, if applicable (paragraphs 31, 32, and 35-41)
  - c. Initially measure at fair value assets obtained and liabilities incurred in a sale (paragraphs 42-44) or, if it is not practicable to estimate the fair value of an asset or a liability, apply alternative measures (paragraphs 45 and 46)
  - d. Recognize in earnings any gain or loss on the sale.  
The transferee shall recognize all assets obtained and any liabilities incurred and initially measure them at fair value (in aggregate, presumptively the price paid).

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<sup>3</sup> Although a transfer of securities may not be considered to have reached completion until the settlement date, this Statement does not modify other generally accepted accounting principles, including *FASB Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans*, and AICPA Statements of Position and audit and accounting Guides for certain industries, that require accounting at the trade date for certain contracts to purchase or sell securities.

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12. If a transfer of financial assets in exchange for cash or other consideration (other than beneficial interests in the transferred assets) does not meet the criteria for a sale in paragraph 9, the transferor and transferee shall account for the transfer as a secured borrowing with pledge of collateral (paragraph 15).

#### Secured Borrowings and Collateral

15. A debtor may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, with or without recourse to other assets of the debtor. An obligor under other kinds of current or potential obligations, for example, interest rate swaps, also may grant a security interest in certain assets to a secured party. If collateral is transferred to the secured party, the custodial arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge (or otherwise transfer) collateral held under a pledge. The same relationships occur, under different names, in transfers documented as sales that are accounted for as secured borrowings (paragraph 12). The accounting for collateral by the debtor (or obligor) and the secured party depends on whether the secured party has taken control over the collateral and on the rights and obligations that result from the collateral arrangement:

- a. If (1) the secured party is permitted by contract or custom to sell or repledge the collateral and (2) the debtor does not have the right and ability to redeem the

- collateral on short notice, for example, by substituting other collateral or terminating the contract, then
- (i) The debtor shall reclassify that asset and report that asset in its statement of financial position separately (for example, as securities receivable from broker) from other assets not so encumbered.
  - (ii) The secured party shall recognize that collateral as its asset, initially measure it at fair value, and also recognize its obligation to return it.
- b. If the secured party sells or repledges collateral on terms that do not give it the right and ability to repurchase or redeem the collateral from the transferee on short notice and thus may impair the debtor's right to redeem it, the secured party shall recognize the proceeds from the sale or the asset repledged and its obligation to return the asset to the extent that it has not already recognized them. The sale or pledging of the asset is a transfer subject to the provisions of this Statement.
  - c. If the debtor defaults under the terms of the secured contract and is no longer entitled to redeem the collateral, it shall derecognize the collateral, and the secured party shall recognize the collateral as its asset to the extent it has not already recognized it and initially measure it at fair value.
  - d. Otherwise, the debtor shall continue to carry the collateral as its asset, and the secured party shall not recognize the pledged asset.

#### Disclosures

17. An entity shall disclose the following:
  - a. If the entity has entered into repurchase agreements or securities lending transactions, its policy for requiring collateral or other security
  - b. If debt was considered to be extinguished by in-substance defeasance under the provisions of FASB Statement No. 76, Extinguishment of Debt, prior to the effective date of this Statement, a general description of the transaction and the amount of debt that is considered extinguished at the end of the period so long as that debt remains outstanding
  - c. If assets are set aside after the effective date of this Statement solely for satisfying scheduled payments of a specific obligation, a description of the nature of restrictions placed on those assets
  - d. If it is not practicable to estimate the fair value of certain assets obtained or liabilities incurred in transfers of financial assets during the period, a description of those items and the reasons why it is not practicable to estimate their fair value
  - e. For all servicing assets and servicing liabilities:
    - (1) The amounts of servicing assets or liabilities recognized and amortized during the period
    - (2) The fair value of recognized servicing assets and liabilities for which it is practicable to estimate that value and the method and significant assumptions used to estimate the fair value
    - (3) The risk characteristics of the underlying financial assets used to stratify recognized servicing assets for purposes of measuring impairment in accordance with paragraph 37
    - (4) The activity in any valuation allowance for impairment of recognized servicing assets—including beginning and ending balances, aggregate additions charged and reductions credited to operations, and aggregate direct write-downs charged against the allowances—for each period for which results of operations are presented.

### Isolation beyond the Reach of the Transferor and Its Creditors

23. The nature and extent of supporting evidence required for an assertion in financial statements that transferred financial assets have been isolated—put presumptively beyond the reach of the transferor and its creditors, either by a single transaction or a series of transactions taken as a whole—depend on the facts and circumstances. All available evidence that either supports or questions an assertion shall be considered. That consideration includes making judgments about whether the contract or circumstances permit the transferor to revoke the transfer. It also may include making judgments about the kind of bankruptcy or other receivership into which a transferor or special-purpose entity might be placed, whether a transfer of financial assets would likely be deemed a true sale at law, whether the transferor is affiliated with the transferee, and other factors pertinent under applicable law. Derecognition of transferred assets is appropriate only if the available evidence provides reasonable assurance that the transferred assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its affiliates, except for an affiliate that is a qualifying special-purpose entity designed to make remote the possibility that it would enter bankruptcy or other receivership (paragraph 57.c.).

24. Whether securitizations isolate transferred assets may depend on such factors as whether the securitization is accomplished in one step or two steps (paragraphs 54-58). Many common financial transactions, for example, typical repurchase agreements and securities lending transactions, isolate transferred assets from the transferor, although they may not meet the other criteria for surrender of control.

### Conditions That Constrain a Transferee

25. Many transferor-imposed or other conditions on a transferee's contractual right to pledge or exchange a transferred asset constrain a transferee from taking advantage of that right. However, a transferor's right of first refusal on a bona fide offer from a third party, a requirement to obtain the transferor's permission to sell or pledge that shall not be unreasonably withheld, or a prohibition on sale to the transferor's competitor generally does not constrain a transferee from pledging or exchanging the asset and, therefore, presumptively does not preclude a transfer containing such a condition from being accounted for as a sale. For example, a prohibition on sale to the transferor's competitor would not constrain the transferee if it were able to sell the transferred assets to a number of other parties; however, it would be a constraint if that competitor were the only potential willing buyer.

### Qualifying Special-Purpose Entity

26. A qualifying special-purpose entity<sup>7</sup> must meet both of the following conditions:

- a. It is a trust, corporation, or other legal vehicle whose activities are permanently limited by the legal documents establishing the special-purpose entity to:
  - (1) Holding title to transferred financial assets
  - (2) Issuing beneficial interests (If some of the beneficial interests are in the form of debt securities or equity securities, the transfer of assets is a securitization.)
  - (3) Collecting cash proceeds from assets held, reinvesting proceeds in financial instruments pending distribution to holders of beneficial interests, and otherwise servicing the assets held
  - (4) Distributing proceeds to the holders of its beneficial interests.
- b. It has standing at law distinct from the transferor. Having standing at law depends in part on the nature of the special-purpose entity. For example, generally, under U.S. law, if a transferor of assets to a special-purpose trust holds all of the beneficial interests, it can unilaterally dissolve the trust and thereby reassume control over the individual assets held in the trust, and the transferor "can effectively assign his interest and his creditors can reach it."<sup>8</sup> In

that circumstance, the trust has no standing at law, is not distinct, and thus is not a qualifying special-purpose entity.

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<sup>7</sup> The description of a special-purpose entity is restrictive. The accounting for transfers of financial assets to special-purpose entities should not be extended to any entity that does not satisfy all of the conditions articulated in this paragraph.

<sup>8</sup> *Scott's Abridgment of the Law on Trusts*, §156 (Little, Brown and Company, 1960), 296.

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#### Agreements That Maintain Effective Control over Transferred Assets

27. An agreement that both entitles and obligates the transferor to repurchase or redeem transferred assets from the transferee maintains the transferor's effective control over those assets, and the transfer is therefore to be accounted for as a secured borrowing, if and only if all of the following conditions are met:

- a. The assets to be repurchased or redeemed are the same or substantially the same as those transferred (paragraph 28).
- b. The transferor is able to repurchase or redeem them on substantially the agreed terms, even in the event of default by the transferee (paragraph 29).
- c. The agreement is to repurchase or redeem them before maturity, at a fixed or determinable price.
- d. The agreement is entered into concurrently with the transfer.

28. To be substantially the same,<sup>9</sup> the asset that was transferred and the asset that is to be repurchased or redeemed need to have all of the following characteristics:

- a. The same primary obligor (except for debt guaranteed by a sovereign government, central bank, government-sponsored enterprise or agency thereof, in which case the guarantor and the terms of the guarantee must be the same)
- b. Identical form and type so as to provide the same risks and rights
- c. The same maturity (or in the case of mortgage-backed pass-through and pay-through securities have similar remaining weighted-average maturities that result in approximately the same market yield)
- d. Identical contractual interest rates
- e. Similar assets as collateral
- f. The same aggregate unpaid principal amount or principal amounts within accepted "good delivery" standards for the type of security involved.

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<sup>9</sup> In this Statement, the term substantially the same is used consistently with the usage of that term in the *AICPA Statement of Position 90-3, Definition of the Term Substantially the Same for Holders of Debt Instruments, as Used in Certain Audit Guides and a Statement of Position*.

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29. To be able to repurchase or redeem assets on substantially the agreed terms, even in the event of default by the transferee, a transferor must at all times during the contract term have obtained cash or other collateral sufficient to fund substantially all of the cost of purchasing replacement assets from others.

30. A call option or forward contract that entitles the transferor to repurchase, prior to maturity, transferred assets not readily obtainable elsewhere maintains the transferor's effective control, because it would constrain the transferee from exchanging those assets, unless it is only a cleanup call.

## Measurement of Interests Held after a Transfer of Financial Assets

### Assets Obtained and Liabilities Incurred as Proceeds

31. The proceeds from a sale of financial assets consist of the cash and any other assets obtained in the transfer less any liabilities incurred. Any asset obtained that is not an interest in the transferred asset is part of the proceeds from the sale. Any liability incurred, even if it is related to the transferred assets, is a reduction of the proceeds. Any derivative financial instrument entered into concurrently with a transfer of financial assets is either an asset obtained or a liability incurred and part of the proceeds received in the transfer. All proceeds and reductions of proceeds from a sale shall be initially measured at fair value, if practicable.

### Securities Lending Transactions

61. Securities lending transactions are initiated by broker-dealers and other financial institutions that need specific securities to cover a short sale or a customer's failure to deliver securities sold. Transferees ("borrowers") of securities generally are required to provide "collateral" to the transferor ("lender") of securities, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than that of the securities "borrowed." If the "collateral" is cash, the transferor typically earns a return by investing that cash at rates higher than the rate paid or "rebated" to the transferee. If the "collateral" is other than cash, the transferor typically receives a fee. Securities custodians or other agents commonly carry out securities lending activities on behalf of clients. Because of the protection of "collateral" (typically valued daily and adjusted frequently for changes in the market price of the securities transferred) and the short terms of the transactions, most securities lending transactions in themselves do not impose significant credit risks on either party. Other risks arise from what the parties to the transaction do with the assets they receive. For example, investments made with cash "collateral" impose market and credit risks on the transferor.

62. In some securities lending transactions, the criteria in paragraph 9 are met, including the third criterion. Those transactions shall be accounted for (a) by the transferor as a sale of the "loaned" securities for proceeds consisting of the "collateral"<sup>11</sup> and a forward repurchase commitment and (b) by the transferee as a purchase of the "borrowed" securities in exchange for the "collateral" and a forward resale commitment. During the term of that agreement, the transferor has surrendered control over the securities transferred and the transferee has obtained control over those securities with the ability to sell or transfer them at will. In that case, creditors of the transferor have a claim only to the "collateral" and the forward repurchase commitment.

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<sup>11</sup> If the "collateral" is a financial asset that the holder is permitted by contract or custom to sell or repledge and the debtor does not have the right and ability to redeem the collateral on short notice, for example, by substituting other collateral or terminating the contract, that financial asset is proceeds of the sale of the "loaned" securities. To the extent that the "collateral" consists of letters of credit or other financial instruments that the holder is not permitted by contract or custom to sell or pledge, a securities lending does not satisfy the sale criteria and is accounted for as a loan of securities by the transferor to the transferee.

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63. However, many securities lending transactions are accompanied by an agreement that entitles and obligates the transferor to repurchase or redeem the transferred assets before their maturity under which the transferor maintains effective control over those assets (paragraphs 27-30). Those transactions shall be accounted for as secured borrowings, in which cash (or securities that the holder is permitted by contract or custom to sell or repledge) received as "collateral" is considered the amount borrowed, the securities "loaned" are considered pledged as collateral against the cash borrowed, and any "rebate" paid to the transferee of securities is interest on the cash the transferor is considered to have borrowed. Collateral provided in securities lending transactions that are accounted for as secured borrowings shall be reported in the statement of financial position like other collateral, as set forth in paragraph 15.



64. The transferor of securities being “loaned” accounts for cash received (or for securities received that may be sold or repledged and were obtained under agreements that are not subject to repurchase or redemption on short notice, for example, by substitution of other collateral or termination of the contract) in the same way whether the transfer is accounted for as a sale or a secured borrowing. The cash (or securities) received shall be recognized as the transferor’s asset—as shall investments made with that cash, even if made by agents or in pools with other securities lenders—along with the obligation to return the cash (or securities).

**Illustration—Securities Lending Transaction Treated as a Secured Borrowing**

65. Accounting for a securities lending transaction treated as a secured borrowing:

**Facts**

|   |         |
|---|---------|
| Transferor’s carrying amount and fair value of security loaned                | \$1,000 |
| Cash “Collateral”   | 1,020   |
| Transferor’s return from investing cash collateral at a 5 percent annual rate | 5       |
| Transferor’s rebate to the borrower at a 4 percent annual rate                | 4       |

The loaned securities cannot be redeemed on short notice, for example, by substitution of other collateral. For simplicity, the fair value of the security is assumed not to change during the 35-day term of the transaction.

**Journal Entries for the Transferor**

*At inception:*

|   |       |       |
|---|-------|-------|
| Cash  | 1,020 |       |
| Payable under securities loan agreements                                |       | 1,020 |
| To record the receipt of cash collateral                                |       |       |
| <br>  |       |       |
| Securities loaned to broker   | 1,000 |       |
| Securities  |       | 1,000 |
| To reclassify loaned securities that cannot be redeemed on short notice |       |       |
| <br>  |       |       |
| Money market instrument   | 1,020 |       |
| Cash  |       | 1,020 |
| To record investment of cash collateral                                 |       |       |

*At conclusion:*

|  |       |       |
|--|-------|-------|
| Cash   | 1,025 |       |
| Interest   |       | 5     |
| Money market instrument                              |       | 1,020 |
| To record results of investment                      |       |       |
| <br>   |       |       |
| Securities   | 1,000 |       |
| Securities loaned to broker                          |       | 1,000 |
| To record return of security                         |       |       |
| <br>   |       |       |
| Payable under securities loan agreements             | 1,020 |       |
| Interest (“rebate”)                                  | 4     |       |
| Cash   |       | 1,024 |
| To record repayment of cash collateral plus interest |       |       |

**Journal Entries for the Transferee**

*At inception:*

|   |       |       |
|---|-------|-------|
| Receivable under securities loan agreements | 1,020 |       |
| Cash  |       | 1,020 |
| To record transfer of cash collateral       |       |       |

|  |       |       |
|--|-------|-------|
| Securities   | 1,000 |       |
| Obligation to return borrowed securities   |       | 1,000 |
| To record receipt of borrowed securities that cannot be redeemed on short notice |       |       |

*At conclusion:*

|  |       |       |
|--|-------|-------|
| Obligation to return borrowed securities                     | 1,000 |       |
| Securities   |       | 1,000 |
| To record the return of securities                           |       |       |
| Cash   | 1,024 |       |
| Receivable under securities loan agreements                  |       | 1,020 |
| Interest revenue ("rebate")                                  |       | 4     |
| To record the receipt of cash collateral and rebate interest |       |       |

**Repurchase Agreements and "Wash Sales"**

69. Furthermore, "wash sales" that previously were not recognized if the same financial asset was purchased soon before or after the sale shall be accounted for as sales under this Statement. Unless there is a concurrent contract to repurchase or redeem the transferred financial assets from the transferee, the transferor does not maintain effective control over the transferred assets.

**RELEVANT LITERATURE****Statutory Accounting**

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies, Chapter 2, *Stocks*
- Accounting Practices and Procedures Manual for Property and Casualty Insurance Companies, Chapter 2, *Stocks*
- *Purposes and Procedures Manual of the NAIC Securities Valuation Office*, Section 5—*Procedures for Valuing Common Stocks and Stock Warrants*
- *Issue Paper No. 4—Definition of Assets and Nonadmitted Assets*
- *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*
- *Issue Paper No. 7—Asset Valuation Reserve and Interest Maintenance Reserve*
- *Issue Paper No. 26—Bonds, excluding Loan-backed and Structured Securities*
- *Issue Paper No. 45—Repurchase Agreements, Reverse Repurchase Agreements and Dollar Repurchase Agreements*
- *Issue Paper No. 73—Nonmonetary Transactions*

**Generally Accepted Accounting Principles**

- *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities*
- *FASB Statement No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*

**State Regulations**

- Delaware Statutes - Insurance Laws, Title 18 Insurance Code, Part I, Chapter 13 - Investments, Section 1311
- Utah Regulations - Utah Administrative Rules, Insurance, R590 Administration, Rule R590-116-- Valuation of Assets
- Massachusetts Statutes - Insurance Laws, PART I. -- Administration of the Government, TITLE XXII-- Corporations, Chapter 175 -- INSURANCE, Powers and Duties of Commissioner of Insurance, 175:11A - Valuation of securities and other investments

- Florida Statutes - Insurance Laws, TITLE XXXVII-- INSURANCE, Chapter 625 -- Accounting, Investments, and Deposits by Insurers, Part I. Assets and Liabilities, 625.151- Securities valuation
- Georgia Regulations, Rules and Regulations of the State of Georgia, TITLE 120. -- Rules of the Comptroller General, 120-2. Insurance Department, Chapter 120-2-5 -- Valuation Procedures and Instructions for Bonds and Stocks, 120-2-5-.01 Establishing Values

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