

# Statutory Issue Paper No. 164

## Preferred Stock

### STATUS

Finalized July 30, 2020

Original SSAP: SSAP No. 32; Current Authoritative Guidance: SSAP No. 32R

### Type of Issue:

Common Area

### SUMMARY OF ISSUE

1. The guidance within this issue paper introduces substantive revisions to *SSAP No. 32—Preferred Stock* pursuant to the Statutory Accounting Principles (E) Working Group’s (Working Group) Investment Classification Project. The Investment Classification Project reflects a comprehensive review to address a variety of issues pertaining to definitions, measurement and overall scope of the investment statements of statutory accounting principles (SSAPs).
2. The substantive revisions to SSAP No. 32 (illustrated in Exhibit A) under the Investment Classification Project, detailed within this issue paper, reflect the following key elements:
  - a. Improves preferred stock definitions, with inclusion of information from U.S. generally accepted accounting principles (GAAP) for classifying preferred stock as redeemable or perpetual. The revisions also incorporate a new exhibit to capture various terms prevalent in preferred stock.
  - b. Revises the measurement guidance to ensure appropriate, consistent measurement based on the type of preferred stock held and the terms of the preferred stock. The revisions also incorporate guidance for mandatory convertible preferred stock.
  - c. Incorporates revisions to clarify impairment guidance as well as guidance for dividend recognition and redemption of preferred stock with the issuer.

### DISCUSSION

3. This issue paper intends to provide information on discussions that occurred when considering revisions to SSAP No. 32 under the Investment Classification Project, as well as the adopted revisions.

### Preferred Stock Definitions

4. The historical definition of preferred stock within SSAP No. 32 is “any class or shares of the holders 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.” This definition has been identified as generally consistent with market terms, including the following NASDAQ and Financial Accounting Standards Board (FASB) definitions for common stock:
  - a. NASDAQ Definition: A security that shows ownership in a corporation and gives the holder a claim, prior to the claim of common shareholders, 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. The stock does not usually carry voting rights. Preferred stock has characteristics of both equity and debt.

- b. FASB Codification: A security that has preferential rights compared to common stock.

5. Comments received from interested parties in October 2019 indicated that the term “security” is not interchangeable as it pertains to preferred stock and requested all references be changed to “interest” or directly reference the type of stock under consideration. In review of the use of the term “security” in the issue paper, most instances represent existing references carried over from SSAP No. 32. NAIC staff recognizes that preferred stock is a “security,” as demonstrated by the definitions from both the NASDAQ and FASB, but NAIC staff has proposed some revisions to limit the generic use of the term. The use of the term “security” in paragraph 8, paragraphs 10-13 and in Exhibit A (as it pertains to defining specific types of preferred stock) has been revised to “preferred stock.” The use of the term “security” in paragraph 3 has been retained as this usage mirrors the FASB definition for preferred stock.

6. NAIC staff’s original intent was to align various investment definitions with common industry definitions or those specified by U.S. GAAP. As a part of the investment reclassification project, this practice began with unaffiliated common stock (SSAP No. 30R) and now has expanded into preferred stock (SSAP No. 32). The definition proposed by NAIC staff was made with the understanding that preferred stock is either redeemable or perpetual. While the issue paper does mention some stock labeled as “redeemable perpetual preferred stock,” distinctions are made in the prospectus as to its true underlying characteristics (thus being redeemable or perpetual). In general, NAIC staff continue to believe that for a majority of preferred stock issuances, a share which is redeemable *at the option* of the holder is by definition redeemable *outside (or not solely within)* the control of the issuer – thus the actions are mutually exclusive. However, interested parties cited guidance for additional circumstances in which, through legal technicalities, could create a third class of preferred shares – those redeemable outside the control of the issuer and holder. Since the definition refers to “outside the control of the issuer” as a determination for classifying a preferred share as *redeemable* (reported at amortized cost), certain circumstances which are technically “not solely within the issuer’s control” could cause shares to be reclassified to redeemable which were originally categorized as perpetual (reported at fair value). ASC 480-10 provides a few of these examples as: change in state law, the issuer fails to achieve certain project milestones, the issuer fails to pay specified dividends, the issuer experiences a change in credit rating, etc. As such, NAIC staff are supportive of the changes suggested by interested parties as they align with the original objective of preferred stock classification and reflect the expected economics of the investment.

7. Although the historical definition of preferred stock in SSAP No. 32 is comparable to current market terms, this issue paper recommends revisions to incorporate the NASDAQ definition as it is more encompassing of the characteristics of preferred stocks.

#### *Definitions and Classification as Redeemable or Perpetual Preferred Stock*

8. The accounting guidance of SSAP No. 32 varies based on whether preferred stock is considered to be “redeemable” or “perpetual.” The historical definitions of redeemable and perpetual within SSAP No. 32R reflected the following:

- a. Redeemable preferred stock is defined as 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.
- b. 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.

9. In comparing these terms to current U.S. GAAP, the guidance in the FASB Accounting Standards Codification (ASC), which is also consistent with Securities Exchange Commission (SEC) guidance, is more detailed in identifying the requirements for classification as redeemable preferred stock:

- a. 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. (FASB ASC 480-10-S99)
- b. 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." (FASB ASC 480-10-S99)

10. In reviewing these definitions, and preferred stock components that permit payment of dividends in stock instead of cash (known as payment-in-kind (PIK) stock), it was identified that preferred stock that incorporates PIK dividends is not limited to redeemable preferred stock as implied in the prior SSAP No. 32 definition for redeemable preferred stock.

11. To ensure classification of redeemable and perpetual preferred stock consistently with U.S. GAAP, the definitions from the FASB ASC have been incorporated into the revised SSAP No. 32.

*Definition of Restricted Stock:*

12. The historical accounting guidance in SSAP No. 32 included a definition of restricted stock 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.” This definition identified that “any portion of the security that can be reasonably expected to qualify for sale within one year is not considered restricted.”

13. In researching this restricted stock definition, it was identified that this guidance was included in the original codification of SSAP No. 32, however, there was no identification of the source of this definition from the issue paper. In reviewing current market terms for restricted stock or restricted securities, definitions and information was noted from both NASDAQ and the SEC:

- a. Restricted Stock (NASDAQ): Stock that must be traded in compliance with special SEC regulations concerning its purchase and resale. These restrictions generally result from affiliate ownership, merger and acquisition (M&A) activity, and underwriting activity.
- b. Restricted Securities (SEC): 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.

14. Using the information from both NASDAQ and the SEC, a revised definition of restricted stock has been incorporated into the revised SSAP No. 32. Additionally, the revisions clarify that restricted stock is generally an admitted asset but highlights that nonadmittance could occur in accordance with *SSAP No. 4—Assets and Nonadmitted Assets*. Under SSAP No. 4, the restrictions limiting use of an asset can be

determined to preclude the ability to consider the asset as available for policyholder claims. In such situations, the restricted asset would be considered nonadmitted.

#### *Definitions or Preferred Stock Components / Characteristics*

15. The historical guidance in SSAP No. 32 included definitions for a couple of preferred stock terms, including “mandatory sinking fund” and “step-up preferred stock,” but did not include definitions of other common preferred stock components or terms. Furthermore, in reviewing the previously included terms, it was identified that they were no longer current and should be revised or removed from SSAP No. 32. For example, the definition of “mandatory sinking fund” included references to preferred stock outstanding in 1978, and the definition of “step-up preferred stock” referred to the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and there is no current accounting or valuation guidance for step-up preferred stock in that Manual.

16. Rather than include a variety of terms in the body of the SSAP, particularly as components may not impact overall accounting and reporting of the preferred stock, a new exhibit has been included to include a glossary of key preferred stock terms. The definitions intend to capture current market-terms for the noted components.

#### **Accounting and Reporting of Preferred Stock**

17. The historical guidance in SSAP No. 32 captured different accounting and reporting provisions based on whether the preferred stock was classified as redeemable or perpetual, and whether the reporting entity maintained an Asset Valuation Reserve (AVR). Although these classifications are still considered appropriate, it has been noted that additional guidance is needed for mandatory convertible preferred stock, and that a review of the various measurement methods permitted (by classification) should occur to ensure appropriate measurement in the financial statements. Specifically, the prior guidance in SSAP No. 32 explicitly permitted “cost” as an applicable measurement method, even for perpetual preferred stock. Consistent with prior conclusions from U.S. GAAP, as well as the Statutory Accounting Principles (E) Working Group, “historical cost” is generally not an acceptable measurement method. Particularly, this measurement method is not acceptable when liquidation of an asset would generally occur at market prices, such as a non-redeemable (perpetual) preferred stock.

18. The changes reflected in the revised SSAP No. 32 continue to differentiate accounting and reporting guidance by whether a reporting entity maintains an AVR and on the type of preferred stock (redeemable or perpetual). However, revisions have been incorporated to clarify the accounting and reporting of mandatory convertible preferred stock and to update the measurement basis for each type of preferred stock:

- a. For redeemable preferred stock, the revisions continue to use NAIC designations in determining the measurement method. There was no change proposed to the measurement basis per designation. However, the revisions clarify that the measurement basis shall be either amortized cost or fair value based on NAIC designation, eliminating reference to “cost” as a measurement method that could be used by a reporting entity. For the amortization of redeemable preferred stock, revisions have also been incorporated to clarify that amortization (or accretion) of any discount or premium is reported through investment income, instead of impacting dividends collected. Recognizing this amortization through investment income is consistent with U.S. GAAP.
- b. For perpetual preferred stock, the revisions have eliminated use of NAIC designations in determining measurement method and the guidance requires use of fair value, not to exceed any stated call price from the prospectus of the preferred stock. As there are no requirements for an issuer to redeem these securities, these securities can continue indefinitely until the issuing entity reacquires the preferred stock at current market rates or elects to buy-back the preferred stock in accordance with rates established in the preferred

stock prospectus. In order to prevent overstatement of the securities in the financial statements, the measurement of these preferred stocks reflects fair value, not to exceed any currently effective<sup>1</sup> buy-back rates (call prices) that the issuer can utilize to redeem the stock. This measurement guidance is not impacted by the type of reporting entity (AVR or non-AVR filer) and is not impacted by NAIC designation. Although not impacted by NAIC designation, this guidance does not change the requirement to report the NAIC designation as the NAIC designation impacts the risk-based capital (RBC) charge attributed to the preferred stock.

- c. For mandatory convertible preferred stock, guidance has been incorporated to require measurement at fair value, not to exceed any stated call price, in the periods prior to conversion. This guidance is applicable regardless if the preferred stock would be classified as redeemable or perpetual and is applicable regardless of NAIC designation. This guidance requires the preferred stock to be measured at the same measurement basis that would be required once converted to common stock. This prevents overstatement in the financial statements at the time of conversion.
- d. For exchange traded funds which qualify for preferred stock treatment from the NAIC SVO, the revisions clarify that these investments shall always be treated as perpetual preferred stock. This classification is appropriate as the fund would not qualify as a redeemable preferred stock with a stated term that allows for amortization.

### Impairment of Preferred Stock

19. The prior guidance in SSAP No. 32 included different guidance for determining other-than-temporary impairment (OTTI) based on whether the preferred stock was redeemable or perpetual. Although this division has been retained, modifications have been reflected as follows:

- a. For redeemable preferred stock, guidance has been captured to require assessment of OTTI whenever mandatory redemption rights or sinking fund requirements do not occur. Although preferred stock may indicate “required” elements, failing to provide dividends, or contribute to a sinking fund, may not be considered an act of default or require liability recognition from the issuer. Not receiving preferred stock provisions does not turn the holder of preferred stock into a creditor, and a redemption right cannot force a company to redeem shares. However, if an issuer fails to comply with “required” components, reporting entities should assess whether the preferred stock is other-than-temporarily impaired.
- b. For perpetual preferred stock, the other-than-temporary impairment guidance has been revised to mirror guidance for other equity investments (e.g., common stock). As perpetual preferred stock will be reported at fair value, upon recognition of an OTTI, any unrealized losses will be realized, and the then current fair value will become the new cost basis. Subsequent variations in fair value are treated as unrealized gains or losses.
- c. Comments received from interested parties noted that proposed impairment guidance for perpetual preferred stock could be enhanced if written similar to existing impairment guidance in *SSAP No. 30R—Unaffiliated Common Stock*. Final proposed language in Exhibit A mimics the language in SSAP No. 30R.

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<sup>1</sup> Interested parties noted that call dates may not be effective for a period of time. As such, language regarding that only “currently effective” buy back rates (call prices) was added.

## Preferred Stock Income / Redemption

20. The guidance in this issue paper incorporates revisions to clarify the reporting of dividend income from preferred stock. This guidance clarifies that dividends shall be recognized in the form received (cash, preferred stock, common stock), at fair value, with differences between fair value and the dividend receivable recognized as gains or losses. Subsequent to initial recognition, the asset received shall follow the applicable statutory accounting statement. For example, dividends received in the form of common stock shall be captured in *SSAP No. 30R—Unaffiliated Common Stock*.

21. Additionally, this issue paper incorporates new guidance to clarify the reporting when preferred stock is reacquired or redeemed by the issuing entity. Pursuant to this guidance, regardless of how an issuer reacquires the stock (either at market value or pre-set call / redemption price), the reporting entity would recognize any difference between the book/adjusted carrying value and the consideration received as a realized gain or loss.

## Disclosures

22. Although this issue paper incorporates various accounting and reporting changes for preferred stock, there have been no revisions incorporated to the existing disclosure requirements.

## Effective Date

23. The adoption of this issue paper by the Statutory Accounting Principles (E) Working Group, and the substantively revised statement of statutory accounting principles (SSAP) occurred on July 30, 2020. The substantive revisions to SSAP No. 32R are detailed in Exhibit A of this issue paper and reflected in the substantively-revised *SSAP No. 32R—Preferred Stock*. The effective date of the guidance will be identified in the SSAP. Users of the *Accounting Practices & Procedures Manual* should note that issue papers are not represented in the Statutory Hierarchy (see Section IV of the Preamble) and therefore the conclusions reached in this issue paper should not be applied until the corresponding SSAP has been adopted by the Plenary of the NAIC.

## RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

### Statutory Accounting

- *SSAP No. 32R—Preferred Stock*

**EXHIBIT A - REVISIONS TO SSAP No. 32—Preferred Stock****Preferred Stock****SCOPE OF STATEMENT**

1. This statement establishes statutory accounting principles for preferred stock.
2. Investments in preferred stock of entities captured in SSAP No. 97—Investments in Subsidiaries, Controlled or Affiliated Entities or SSAP No. 48—Joint Ventures, Partnerships and Limited Liability Companies<sup>1</sup>, including as well as preferred stock interests of certified capital companies (~~CAPCO~~) per INT 06-02: Accounting and Reporting for Investments in a Certified Capital Company (CAPCO) are included within the scope of this statement. The requirement to file investments in preferred stock of certain subsidiaries, controlled or affiliated entities with the NAIC pursuant to SSAP No. 97 does not affect the application of the accounting, valuation or admissibility under this statement. In addition to the provisions of this statement, preferred stock investments in SCAs are also subject to the provisions of SSAP No. 25—Affiliates and Other Related Parties and SSAP No. 97—Investments in Subsidiary, Controlled and Affiliated Entities.

**SUMMARY CONCLUSION**

3. Preferred stock which may or may not be publicly traded; is a security that represents ownership of 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. Preferred stock does not usually carry voting rights. Preferred stock has characteristics of both common stock and debt. ~~defined as any class or series of shares 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 (as defined in SSAP No. 30R—Unaffiliated Common Stock) issued by an entity.~~ Preferred stock shall include ~~but not be limited to:~~
  - a. Redeemable preferred stock, which is preferred stock subject to mandatory redemption requirements or whose redemption is at the option of the holders. Redeemable preferred stock is any stock which 1) 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; or 2) is redeemable at the option of the holders. Preferred stock which meet one or more of these criteria would be classified as redeemable preferred stock,<sup>2</sup> regardless of other attributes such as voting rights or dividend rights. ~~including mandatory sinking fund preferred stock and preferred stock redeemable at the option of the holder;~~
  - b. Perpetual preferred stock, which is preferred stocks which are not redeemable or for which redemption is not at the option of the holder (non-redeemable preferred stock). Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock pursuant to paragraph 3.a. ~~including nonredeemable preferred stock and preferred stock redeemable at the option of the issuer; and~~

<sup>1</sup> Certain legal entities captured in SSAP No. 48, such as LLCs that are corporate-like, do not issue preferred stock in legal form, but instead issue identical instruments labeled preferred units, interests, or shares. These instruments shall be captured in this statement provided they meet the structural characteristics as defined in paragraph 3. Additionally, these instruments shall not be in-substance common stock in which the holder has risk and reward characteristics that are substantially similar to common stock.

<sup>2</sup> Preferred stock shall be classified by its characteristics. For example, a preferred stock that is named “redeemable perpetual preferred stock” shall be reported as either “redeemable” or “perpetual” preferred stock based on whether the characteristics of paragraph 3.a. are met.

4. The definition of preferred stock, as defined in paragraph 3, does not include fund investments. However, the following types of SVO-identified investments are captured within scope of this statement.

e.a. Exchange Traded Funds, which qualify for preferred stock treatment, as identified in Part Three of the *Purposes and Procedures Manual of the NAIC Investment Analysis Office* and published on the SVO's web page at [www.naic.org](http://www.naic.org). SVO-identified preferred stock ETFs shall follow the accounting provisions for perpetual preferred stock.

~~4. Redeemable preferred stock is defined as 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.~~

~~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.~~

~~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.~~

~~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.~~

8.5. Restricted preferred stock is defined<sup>3</sup> as ~~a security either redeemable or perpetual preferred stock that must be traded in compliance with special Securities Exchange Commission (SEC) regulations concerning its purchase and resale. These restrictions generally result from affiliate ownership, merger and acquisition (M&A) activity and underwriting activity. Pursuant to the SEC, 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 the holding may not resell the stock in the public marketplace unless the sale is exempt from the SEC's registration requirements. Restricted preferred stock is generally considered an admitted asset; however, admittance may be limited based on the degree of restriction in accordance with SSAP No. 4—Assets and Nonadmitted Assets. Restricted preferred stock shall be coded as restricted in the investment schedule and disclosed pursuant to SSAP No. 1—Accounting Policies, Risks & Uncertainties, and Other Disclosures.~~ 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.

9.6. Preferred stocks meet the definition of assets as defined in SSAP No. 4—Assets and Nonadmitted Assets and are admitted assets to the extent they conform to the requirements of this statement, SSAP No. 25 and SSAP No. 97.

<sup>3</sup> This definition of restricted stock does not preclude a "restricted asset" classification for any preferred stock that is restricted (e.g., not under the exclusive control of the entity) by actions of the reporting entity or others. For example, if a reporting entity has pledged preferred stock, or used preferred stock in securities lending / repo transactions, the preferred stock shall be coded and disclosed as restricted stock pursuant to SSAP No. 1—Accounting Policies, Risks & Uncertainties and Other Disclosures.



## Acquisitions and Sales

~~10.7.~~ At acquisition, preferred stock shall be reported at cost, including brokerage and other related fees. PIK Preferred stock received as dividends shall be recorded at fair value. Acquisitions and dispositions shall be recorded on the trade date. Private placement stock transactions shall be recorded on the funding date.

~~11.8.~~ A reporting entity 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. Preferred stock acquired under a subscription represents a conditional transaction in ~~which a security preferred stock is~~ authorized for issuance but not yet actually issued. Such transactions are settled if and when the actual ~~security preferred stock~~ is issued and the exchange or National Association of Securities Dealers (NASD) rules that the transactions are to be settled. Preferred 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 preferred stock~~ and the ~~security preferred stock~~ is recorded in the name of the reporting entity or its nominee, (i.e., the accounting for such preferred stock acquisitions shall be on the settlement date).

## Amortization

~~12.9.~~ Redeemable preferred stock purchased at a premium shall be amortized to reduce the carrying value to the call or redemption value over the period to the call or earliest redemption date, whichever produces the lowest asset value (yield to worst). Redeemable preferred stock purchased at a discount shall be ~~amortized~~ accreted to increase the carrying value to ~~par value~~ the redemption price over the period to maturity or the latest redemption date.

~~13. — PIK preferred stock shall be amortized to the lower of the call price or par value, measured in either case at the end of the stock dividend period and based on all of the shares expected to be held at the end of that period, including those received as dividends.~~

~~14.10.~~ Amortization (and accretion) of the premium and discount arising at acquisition shall be calculated using the interest method and shall be reported through investment income ~~as increases or decreases in dividends collected during the year.~~

## Balance Sheet Amount

~~15. — The NAIC Securities Valuation Office assigns preferred stocks NAIC designations (NAIC designation 1 through 6) in accordance with the *Purposes and Procedures Manual of the NAIC Investment Analysis Office*, and that NAIC designation is published in accordance with the SVO compilation instructions in the *Purposes and Procedures Manual*.~~

~~16.11.~~ Preferred stock shall be valued based on (a) the underlying characteristics ~~of the security~~ (redeemable, ~~or~~ perpetual or mandatory convertible), (b) the quality rating ~~of the security~~ expressed as an NAIC designation ~~pursuant to paragraph 15~~, and (c) whether an asset valuation reserve (AVR) is maintained by the reporting entity:-

a. For reporting entities that do not maintain an AVR:

~~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*.~~

~~18. — For reporting entities required to maintain an AVR, the accounting for unrealized gains and losses shall be in accordance with *SSAP No. 7 Asset Valuation Reserve and Interest Maintenance Reserve*. For reporting entities not required to maintain an AVR, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus).~~

### Reporting Entities That Do Not Maintain An AVR

- ~~19.i.~~ Highest-quality or high-quality redeemable preferred stocks (NAIC designations 1 and 2), which have characteristics of debt securities, shall be valued at cost or amortized cost. All other redeemable preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost, amortized cost, or fair value.
- ~~20.ii.~~ ~~Highest quality or high quality p~~Perpetual preferred ~~stocks (NAIC designations 1 and 2), which have characteristics of equity securities,~~ shall be reported at fair value, not to exceed any currently effective call price. ~~All other perpetual preferred stocks (NAIC designations 3 to 6) shall be reported at the lower of cost or fair value.~~
- iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.
- iv. For preferred stocks reported at fair value, unrealized gains and losses shall be recorded as a direct credit or charge to unassigned funds (surplus)
- b. For reporting entities that maintain an AVR:

### Reporting Entities That Do Maintain An AVR

- ~~21.i.~~ Highest-quality, high-quality or medium quality redeemable preferred stocks (NAIC designations 1 to 3), ~~which have characteristics of debt securities,~~ shall be valued at ~~cost or~~ amortized cost. All other redeemable preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of ~~cost,~~ amortized cost, or fair value.
- ~~22.ii.~~ ~~Highest quality, high quality or medium quality p~~Perpetual preferred stocks ~~(NAIC designations 1 to 3), which have characteristics of equity securities,~~ shall be valued at fair value, not to exceed any currently effective call price. ~~cost. All other perpetual preferred stocks (NAIC designations 4 to 6) shall be reported at the lower of cost or fair value.~~
- iii. Mandatory convertible preferred stocks (regardless if the preferred stock is redeemable or perpetual) shall be reported at fair value, not to exceed any currently effective call price, in the periods prior to conversion. Upon conversion to common stock, these securities shall be in scope of SSAP No. 30R.
- iv. For preferred stocks reported at fair value, the accounting for unrealized gains and losses shall be in accordance with SSAP No. 7—Asset Valuation Reserve and Interest Maintenance Reserve.

### Impairment of Redeemable Preferred Stock

~~23.12.~~ An other-than-temporary<sup>(INT 06-07)</sup> impairment shall be considered to have occurred if it is probable that the reporting entity will be unable to collect all amounts due according to the contractual terms of the ~~security~~preferred stock in effect at the date of acquisition. An assessment of other-than-temporary impairment shall occur whenever mandatory redemption rights or sinking fund requirements do not occur. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell the preferred stock~~a security~~ prior to its maturity at an amount below its carrying value (i.e., amortized cost). If it is determined that a decline in the fair value of a redeemable preferred stock

is other-than-temporary, an impairment loss shall be recognized as a realized loss equal to the entire difference between the redeemable preferred stock's carrying value and its fair value, not to exceed any currently effective call price, at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date. For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7.

~~24.13.~~ In periods subsequent to the recognition of other-than-temporary impairment loss for a redeemable preferred stock, the reporting entity shall account for the other-than-temporarily impaired preferred stock security as if the preferred stock security had been purchased on the measurement date of the other-than-temporary impairment, ~~and in accordance with paragraph 19 or paragraph 21, as applicable~~. The fair value of the redeemable preferred stock on the other-than-temporary impairment measurement date shall become the new cost basis of the redeemable preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. The discount or reduced premium recorded for the preferred stock security, based on the new cost basis, shall be amortized over the remaining life of the preferred stock security in the prospective manner based on the amount and timing of future estimated cash flows. The preferred stock security shall continue to be subject to impairment analysis for each subsequent reporting period. Future declines in fair value which are determined to be other-than-temporary shall be recorded as realized losses.

### Impairment of Perpetual Preferred Stock

~~25.14.~~ ~~If it is determined that a decline in the fair value of a perpetual preferred stock is~~ For any decline in the fair value of perpetual preferred stock, which is determined to be other-than-temporary <sup>(INT 06-07)</sup>, the perpetual preferred 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. ~~an impairment loss shall be recognized as a realized loss equal to the entire difference between the perpetual preferred stock's carrying value and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment loss shall not include partial recoveries of fair value subsequent to the balance sheet date.~~ For reporting entities required to maintain an AVR, realized losses shall be accounted for in accordance with SSAP No. 7. Subsequent fluctuations in fair value shall be recorded as unrealized gains or losses. Future declines, which are determined to be other-than-temporary, shall be recognized as realized losses. A decline in fair value which is other-than-temporary includes situations where the reporting entity has made a decision to sell a preferred stock security at an amount below its carrying value.

~~26.~~ ~~— In periods subsequent to the recognition of an other than temporary impairment loss for a perpetual preferred stock, the reporting entity shall account for the other than temporarily impaired security as if the security had been purchased on the measurement date of the other than temporary impairment, and in accordance with paragraph 20 or paragraph 22, as applicable. The fair value of the perpetual preferred stock on the measurement date shall become the new cost basis of the perpetual preferred stock and the new cost basis shall not be adjusted for subsequent recoveries in fair value. Future declines in fair value which are determined to be other than temporary, shall be recorded as realized losses.~~

### Income

~~27.15.~~ Dividends on preferred stock ~~(whether cumulative or noncumulative), other than mandatorily redeemable preferred stock,~~ shall be recorded as investment income for dividend-eligible preferred stock on the ex-dividend date with a corresponding receivable to be extinguished upon dividend settlement receipt of cash (i.e., dividend income shall be recorded on preferred stock declared to be ex-dividend on or prior to the statement date). Dividends received shall be recognized in the form received (e.g., cash, preferred stock, common stock) at fair value with differences between fair value and the dividend receivable recognized as gains or losses. Subsequent treatment shall follow the statement that addresses the type of asset received. For example, dividends received in the form of common stock shall be accounted for and reported in accordance with SSAP No. 30R.

### Redemption of Preferred Stock

16. A reporting entity that sells or redeems preferred stock back to the issuer shall recognize consideration received in excess of the book/adjusted carrying value as a realized gain or loss. This recognition shall occur regardless of whether the issuer repurchases the preferred shares at market value, or if the shares are redeemed by the issuer at a predetermined set call price.

~~28. Dividends on mandatorily redeemable preferred stock shall be accrued to the redemption price, even if not declared, using the interest method over the period ending on the redemption date.~~

~~29. Cash dividends paid on PIK stock during the stock dividend period shall be accounted for as a reduction in the investment.~~

### **Exchanges and Conversions**

~~30.~~17. If preferred stock is exchanged or converted into other securities, the fair value of the preferred stock surrendered at the date of the exchange or conversion shall become the cost basis for the new securities with any gain or loss realized at the time of the exchange or conversion. However, if the fair value of the securities received in an exchange or conversion is more clearly evident than the fair value of the preferred stock surrendered, then it shall become the cost basis for the new securities.

### **Disclosures**

~~31.~~18. The following disclosures regarding preferred stocks shall be made in the financial statements:

- a. Fair values in accordance with *SSAP No. 100R—Fair Value*;
- b. Concentrations of credit risk in accordance with *SSAP No. 27*;
- c. Basis at which the preferred stocks are stated; and
- d. A description, as well as the amount, of preferred stock that is restricted and the nature of the restriction.
- e. For each balance sheet presented, all preferred stocks in an unrealized loss position for which other-than-temporary declines in value have not been recognized
  - i. The aggregate amount of unrealized losses (that is, the amount by which cost or amortized cost exceeds fair value) and
  - ii. The aggregate related fair value of preferred stocks with unrealized losses.
- f. The disclosures in (i) and (ii) above should be segregated by those preferred stocks that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 months or longer using fair values determined in accordance with *SSAP No. 100R*.
- g. As of the date of the most recent balance sheet presented, additional information should be included describing the general categories of information that the investor considered in reaching the conclusion that the impairments are not other-than-temporary.
- h. When it is not practicable to estimate fair value, the investor should disclose the following additional information, if applicable, as of each date for which a statement of financial position is presented in its annual financial statements:

- iii. The aggregate carrying value of the investments not evaluated for impairment, and
- iv. The circumstances that may have a significant adverse effect on the fair value.

~~32-19.~~ Refer to the Preamble for further discussion regarding disclosure requirements. The disclosure requirements of paragraphs ~~3+18.b.~~, ~~3+18.e.~~, ~~3+18.f.~~, ~~3+18.g.~~ and ~~3+18.h.~~ shall be included in the annual audited statutory financial reports only.

### Relevant Literature

~~33-20.~~ This statement rejects *ASU 2018-03, Recognition and Measurement of Financial Assets and Financial Liabilities*, *ASU 2016-01, Financial Instruments – Overall*, *FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities* and *FASB Emerging Issues Task Force No. 86-32, Early Extinguishment of a Subsidiary’s Mandatorily Redeemable Preferred Stock*. This statement adopts *FASB Staff Position 115-1/124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, paragraph 16, with modification to be consistent with statutory language in the respective statutory accounting statements.

### Effective Date and Transition

~~34-21.~~ This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*. The guidance in paragraphs 23-26 was previously included within *SSAP No. 99—Accounting for Securities Subsequent to an Other-Than-Temporary Impairment* and was effective for reporting periods beginning on January 1, 2009, and thereafter, with early adoption permitted. In 2010, the guidance from *SSAP No. 99* was incorporated within the impacted standards, with *SSAP No. 99* superseded. The original impairment guidance included in this standard, and the substantive revisions reflected in *SSAP No. 99* are retained for historical purposes within *Issue Paper No. 131*. The guidance in paragraphs 2 and 3 to *SSAP No. 32* was originally superseded January 1, 2005, by guidance included in *SSAP No. 88—Investments in Subsidiaries, Controlled and Affiliated Entities, A replacement of SSAP No. 46*, and then subsequently reflected in *SSAP No. 97*. In 2011, the guidance related to preferred stock of SCAs from *SSAP No. 97* was incorporated into this statement and revised to reflect a definition of preferred stock. The original guidance included in this statement, and the substantive revisions reflected in *SSAP No. 88* and *SSAP No. 97* (including the title change already reflected in *SSAP No. 32*) are retained for historical purposes within *Issue Paper Nos. 32* and *118*. Guidance in paragraph 17 was originally contained in *INT 99-29: Classification of Step-Up Preferred Stock* and was effective December 6, 1999.

[22. On July 30, 2020, substantive revisions, as detailed in Issue Paper No. 164—Preferred Stock were adopted. These revisions, effective January 1, 2021, update definitions of preferred stock and reporting values based on characteristics of the preferred stock.](#)

### REFERENCES

#### Other

- *Purposes and Procedures Manual of the NAIC Investment Analysis Office*
- NAIC Valuation of Securities product prepared by the Securities Valuation Office

**Relevant Issue Papers**

- *Issue Paper No. 32—Investments in Preferred Stock (excluding investments in preferred stock of subsidiary, controlled, or affiliated companies)*
- *Issue Paper No. 131—Accounting for Certain Securities Subsequent to an Other-Than-Temporary Impairment*
- [\*Issue Paper No. 164—Preferred Stock\*](#)

**EXHIBIT A – GLOSSARY**

**Callable Preferred Stock** – A preferred stock in which the issuer has the right to call or redeem the stock at a preset price after a defined date. Callable preferred stock can be either redeemable preferred stock or perpetual preferred stock depending on other characteristics of the preferred stock. For example, callable preferred stock with a maturity or a specific buyback date would be redeemable preferred stock, whereas callable preferred stock electable at the discretion of the issuer is perpetual preferred stock.

**Convertible Preferred Stock** – A preferred stock 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).

**Cumulative Preferred Stock** – A preferred stock with a provision that missed dividend payments must be paid to cumulative preferred shareholders before other classes of preferred stock shareholders and common shareholders can receive dividend payments. Cumulative preferred stock may have different levels, with a “first” or “senior” cumulative preferred, “regular” cumulative preferred and “subordinate” cumulative preferred that determines the priority in which accumulated unpaid dividends or asset liquidation occurs. (Under SSAP No. 32R, holders of cumulative preferred stock are not permitted to recognize a receivable for unpaid cumulative dividends until declared and the reporting entity is entitled to the dividend.)

**Dividend Declaration Date** – The date a corporation declares a dividend payment to its shareholders.

**Dividend Record Date** – The date that identifies the shareholders that are entitled to a declared dividend.

**Dividend Payment Date** – The date the declared dividend will be paid.

**Ex-Dividend Date** – The cut-off date of holding stock to be captured as a shareholder on record entitled to the dividend. (A shareholder that sells their stock on the ex-dividend date would continue to be identified as a shareholder on record entitled to a declared dividend. Anyone who acquires a stock on the ex-dividend date would not be a shareholder on record entitled to a declared dividend.)

**Mandatory Redeemable Preferred Stock** – A preferred stock that embodies 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. (The existence of a mandatory redemption right does not convert the holder of a preferred stock into a creditor, and an issuer may be prohibited from redeeming shares when redemption would cause an impairment of capital.)

**Noncumulative Preferred Stock** – A preferred stock that does not entitle the stockholder to accumulated unpaid dividends. After missing dividend payments, a corporation only has to make current dividend payments to preferred stock holders before providing dividends to common stock holders.

**Participating Preferred Stock** – A preferred stock that gives the holder participation in the additional earnings of a business or liquidation rights in addition to the normal preferred stock dividend. Pursuant to the terms of the preferred stock, the participation rights may only be activated when income or operations of the issuer exceeds a certain threshold level.

**Payment-in-kind (PIK)** – A term of the preferred stock prospectus that identifies that dividends may take the form of securities (e.g., common stock) rather than cash.

**Perpetual Preferred Stock** - Preferred stocks which are not redeemable or are redeemable solely at the option of the issuer. Perpetual preferred stock is any preferred stock which does not meet the criteria to be classified as redeemable preferred stock.

**Preferred stock** - A security, which may or may not be publicly traded, that shows ownership of 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.

**Redeemable Preferred Stock** - Preferred stock subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. Redeemable preferred stock is any stock which 1) 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; 2) is redeemable at the option of the holders; or 3) has conditions for redemption which are not solely within the control of the issuer, such as stock which must be redeemed out of future earnings. Preferred stock which meet one or more of these three criteria is redeemable preferred stock regardless of other attributes such as voting rights or dividend rights.

**Restricted Preferred Stock** - Redeemable or perpetual preferred 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. Pursuant to the SEC, 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 the holding may not resell the stock in the public marketplace unless the sale is exempt from the SEC’s registration requirements.

**Sinking Fund** – A potential component of a preferred stock charter that requires the issuer to regularly set funds aside in a separate custodial account for the exclusive purpose of redeeming preferred stock shares. Failure of an issuer to provide to the sinking fund does not create an act of default. Rather, the stock charter may implement provisions for failing to provide to the sinking fund, which could include penalties, restrictions of providing common stock dividends or the repurchase of the preferred stock.

**Step-Up Preferred Stock** – A potential component of a preferred stock charter that identifies whether specific terms will increase over time or with stated provisions. For example, a “step-up dividend” is a feature that increases the dividend rate. A “step-up call” is a feature that increases the call price. A “step-up conversion” increases the conversion price.

**Term Preferred Stock** – Preferred stock with a mandatory redemption requirement (maturity date) captured in the definition of redeemable preferred stock.