



Credit Union Alert

FASB Update Now in Effect

What the new rules mean for credit unions and equity securities

INTRODUCTION

Utilizing equity securities, like stocks, mutual funds, and exchange-traded funds, has historically been a reasonable way to invest credit union assets. But now, due to updated accounting guidelines, these types of investments may not be as appropriate as they once were.

The Financial Accounting Standards Board (FASB) has issued a new guidance that impacts all entities holding financial assets, including credit unions, by changing the standards of an equity security. The guidance forces credit unions to report any losses on stocks, mutual funds, and ETFs on their current net income statements, even if those investments are designed to be held for the long-term to meet future obligations like funding executive retirement plans. The guidance came into effect December 15, 2018, and the volatility of equity securities can cause a number of issues for credit unions if they don't transition their portfolios to more stable and predictable assets soon.

Many of the changes are built around transparency, reducing financial liability, and establishing “fair value” for financial instruments

Let's take a look at what is happening under the FASB's new guidance, why this change came to pass, and what credit unions can do to ensure that they make the right choices when it comes to equity securities.

WHAT'S HAPPENING

In January 2016, the FASB released an Accounting Standards Update (ASU 2016-01) on “financial instruments” to better establish their reporting model. According to the update release: “The amendments improve financial reporting by providing relevant information about an entity's equity investments and reducing the number of items that are recognized in other comprehensive income.” Many of the changes are built around transparency, reducing financial liability, and establishing “fair value” for financial instruments.

It also explains the amendments as including a disclosure of fair value of financial instruments measured at an amortized cost:

“This change to GAAP eliminates the entry price method previously used by some entities for disclosure purposes for some financial assets. Previously, GAAP permitted entities an option to measure fair value in

two different ways. This change results in increased comparability between fair values of financial instruments held by different entities and provides users with more comparable information as compared with current practice.”

While this may seem like a good idea to those who want simpler reporting, the impact on the current balance sheet for organizations that hold volatile investments will be significant. The FASB has redefined the standards that govern an equity security, instead defining it as “any security representing an ownership interest in an entity...at fixed or determinable prices.”

Although price changes in equity securities were previously recorded as Unrealized Gains or Losses, under the new standard, price changes must be recorded directly in Net Income instead.

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If your credit union currently owns any stocks, mutual funds, or ETFs – and it's very likely that it does, under the new definition, its going to be subject to Fair Value Through Net Income. This is where financial institutions, not just credit unions, come upon the biggest stumbling blocks.

FVTNI is something of a small disaster when it comes to equity securities. Think about stocks, mutual funds, ETFs, and the like – their values fluctuate depending on the market. But under proposed ASU 2016-01, the price changes could appear to be more out of control, making it difficult for any financial institution to provide a solid forecast. With FVTNI, a portfolio may look as though it's taking incredible losses over a few calendar months, only to right itself again by the end of the year.

Although a portfolio's earnings with FVTNI may seem to be solid overall, if you drill down and look at some of the more volatile months, you can see how income could be completely wiped out by only a few swift downturns in the market.

Even if hypothetically an FVTNI column likely projected higher Total Income than the one under the current ATS calculation, this income came about through some rocky calculations. Under the new guidance, it will be far more difficult to justify a portfolio that has such uncertainty, let alone one that can't accurately be predicted or forecasted.

A CREDIT UNION'S BEST GAME PLAN

The FASB's ASU 2016-01 guidance took effect December 15, 2018. There are steps that credit unions need to start taking now in order to ensure a smooth transition for their equity securities.

The first step is to consider their alternative investment options. It's important to have a wide range of offerings, but with ASU 2016-01 and FVTNI, options like mutual funds and stocks are not the most stable choices. Instead, credit unions need to look to investment solutions that put the emphasis on three things: minimal volatility, predictability, and flexibility.

Credit Union-Owned Life Insurance (CUOLI) is an alternative to stocks, mutual funds, and ETFs. It minimizes investment volatility, while retaining a high level of predictability and flexibility. In fact, many credit unions already own life insurance, since the NCUA approved of its use as a way to fund executive benefits back in 2006.

By acquiring well-designed permanent insurance policies on the lives of key employees, credit unions can earn income through the growth of the cash value and the ultimate payment of the death benefit. Most policies provide crediting guarantees to minimize volatility and maximize predictability, and offer the flexibility to take out cash using policy loans or withdrawals. Credit unions should consider engaging institutional life insurance advisors in order to ensure that the transition goes smoothly. They can ensure that the due diligence process is done above board, constantly monitor the performance of the CUOLI, and provide administrative and accounting entry support.

the conclusion

Stay Adaptable

When something like the FASB's ASU 2016-01 guidance occurs, it serves as a reminder to credit unions to be adaptable and flexible to change, and to have access to a wider variety of investment options.

Although ASU 2016-01 may seem like a reason to be concerned, it's actually a great opportunity for credit unions to re-evaluate their holdings, learn about other available options, and seek out those that minimize the income statement effect of Fair Value reporting. And, if these new investment strategies have the liquidity and flexibility to make changes in the future, well, that's all the better.

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