




# ASU 2016-01

## Recognition and Measurement of Financial Assets and Liabilities

It's Not CECL, But It Could Affect You



You likely are aware of ASU 2016-01, which requires that “public business entities” report in footnote disclosures loans and debt securities at fair value using an exit price concept rather than an entry price notion. In completing the fair value footnote disclosures for loan portfolios, banks may use fair value estimates derived from their asset/liability management models. However, reliance on ALCO models suffers from several weaknesses when viewed from the perspective of achieving an exit price measurement. This article discusses ASU 2016-01 and its possible implications for your institution’s disclosure obligations.

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In listening to presenters at the recent AICPA National Conference on Banks & Savings Institutions, we gathered that some banks are taking their first fitful steps toward implementing the pending accounting rule governing credit impairment. Bankers should not lose sight, however, of another FASB pronouncement that becomes effective, for most banks, in the first quarter of 2018. Accounting Standards Update No. 2016-01 addresses the recognition and measurement of financial assets and liabilities.

## History of ASU 2016-01

A long and winding history preceded the issuance of ASU 2016-01. In 2010, the FASB drafted a predecessor to ASU 2016-01, which required that financial statement issuers carry most financial instruments at fair value. As a result, assets and liabilities presently reported by banks at amortized cost, such as loans, would be marked periodically to fair value. This proposal was almost universally scorned, satisfying neither financial statement issuers nor investors. The FASB followed with a revised exposure draft in 2013, which maintained amortized cost as the measurement methodology for many financial instruments. Stakeholders objected, however, to a new framework in the 2013 exposure draft that linked the measurement method (fair value or amortized cost) to the nature of the investment and the issuer’s anticipated exit strategy. The FASB agreed with these concerns, eliminating this framework from the final rule on cost/benefit grounds.

The final pronouncement issued in January 2016 generally maintains existing GAAP for debt instruments, including loans and debt securities. However, the standard modifies current GAAP for equity investments, generally requiring issuers to carry such investments at fair value. Restricted equity securities commonly held by banks, such as stock in the Federal Reserve or Federal Home Loan Bank, are excluded from the scope of ASU 2016-01; therefore, no change in accounting for these investments will occur. Excluding these restricted investments, community banks typically do not hold equity securities, and we do not discuss the accounting for equity investments in this article. Interested readers may wish to review a previous Mercer Capital article summarizing certain changes that ASU 2016-01 makes to equity investment accounting.

## Entry vs. Exit Pricing

While ASU 2016-01 maintains current accounting for debt instruments, it does contain several revisions to the fair value disclosures presented in financial statement footnotes. Originally issued via SFAS 107, these requirements were codified in ASC Topic 825, *Financial Instruments*. Although ASU 2016-01 makes several changes to the qualitative and quantitative disclosures that are beyond the scope of this article, the most significant revisions are as follows:

- » “Public Business Entities” must report the fair value of financial instruments using an “exit” price concept, rather than an “entry” price notion.<sup>1</sup>
- » Non-Public Business Entities are no longer required to present the fair value of financial instruments measured at amortized cost, such as loans, in their footnote disclosures.

Current GAAP is ambiguous regarding whether the fair value of financial instruments measured at amortized cost should embrace an “entry” or “exit” price notion. According to the FASB, this has led to inconsistent disclosures between issuers holding otherwise similar financial instruments. Certain sections of ASC Topic 825, which carried over from SFAS 107, could be construed as permitting an “entry price” measurement. For example, existing GAAP provides an illustrative footnote disclosure describing an entity’s fair value estimate for loans receivable:

*The fair value of other types of loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. [ASC 825-10-55-3, which is superseded by ASU 2016-01]*

By referencing “current rates” on “similar loans,” the guidance implicitly suggests an “entry” price notion, which represents the price paid to acquire an asset. Instead, ASC Topic 820, *Fair Value Measurement*, which was issued subsequent to SFAS 107, clearly defines fair value as an exit price; that is, the price that would be received upon selling an asset.

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<sup>1</sup> The definition of a “public business entity” is broader than the term may suggest. A registrant with the SEC is clearly a PBE, but the definition also includes issuers with securities “traded, listed, or quoted on an exchange or an **over-the-counter market**” (emphasis added). A number of banks “trade” on an over-the-counter market and therefore would appear to be deemed PBEs, even if they are not an SEC registrant. The following entities are also deemed PBEs:

- Entities filing Securities Act compliant financial reports with a banking regulator, rather than the SEC.
- Entities subject to law or regulation requiring such institutions to make publicly available GAAP financial statements, if there are no contractual restrictions on transfer of its securities.



## Limitations of ALCO Models

In our experience, banks often use fair value estimates derived from their asset/liability management models in completing the fair value footnote disclosures for loan portfolios. Reliance on ALCO models suffers from several weaknesses when viewed from the perspective of achieving an exit price measurement:

- 1. The discount rates applied in the ALCO model to the loan portfolio's projected cash flows utilize current issuance rates on comparable loans.** In certain market environments, the entry price for a loan portfolio developed using this methodology may not differ materially from its exit value. However, this approach becomes problematic when economic or financial market conditions suddenly change or the bank ceases underwriting certain loan types.
- 2. The treatment of credit losses is not directly observable.** Instead, the ALCO model implicitly assumes that the discount rates applied to the portfolio's projected cash flow capture the inherent credit risk. However, this process does not necessarily correlate the fair value measurement to underlying credit risk. For example, a bank's automobile loans underwritten in 2015 may be underperforming expectations at origination and also performing poorly compared with 2016 and 2017 originations. The fair value measurement should not apply the same discount rate to each vintage, given the disparate credit performance.

## Compliance Guidance

Complying with the revised disclosure requirements of ASU 2016-01, therefore, may necessitate that banks adopt new methodologies to determine the fair value of the bank's loan portfolio. Mercer Capital has significant experience in determining the fair value of loan portfolios from which we offer the following guidance:

- » ASC 820 emphasizes the use of valuation inputs derived from market transactions, but such transactions seldom occur among loan portfolios similar in nature to those held by community banks. If available, market data should take precedence.
- » Absent market transactions, banks will rely on a discounted cash flow analysis to determine an exit price. To a limited extent, this is consistent with current ALCO modeling, but achieving an exit price requires additional considerations. While valuation should be tailored to each portfolio's characteristics, certain common elements are embedded in Mercer Capital's determinations of a loan portfolio's exit value:
  - 1. Contractual cash flows.** Consistent with current ALCO forecasting models, contractual cash flow estimates should be projected using a loan's balance, interest rate, repricing characteristics, maturity, and borrower payment amounts.

2. **Loan Segmentation.** To create homogeneous groups of loans for valuation purposes, the portfolio should be segmented based on criteria such as loan type and credit risk. Credit risk, as measured by metrics such as delinquency status or loan grade, can be manifest in the fair value analysis either through the credit loss forecast or the discount rate derivation.
3. **Prepayments.** The contractual cash flows should be adjusted for potential prepayments, based on market estimates, as available, or the bank's recent experience.
4. **Credit Losses.** If not considered in the discount rate derivation, the projected cash flows should be adjusted for potential defaulted loans. In a fair value measurement this is a dynamic, forward-looking concept. It also is consistent with the notion in the Current Expected Credit Loss model—which underlies the recent FASB pronouncement regarding credit losses—that credit losses should be measured over the life of the loan.
5. **Discount Rate.** The discount rate should be viewed from the perspective of a market participant, given current financial conditions and the nature of the cash flow forecast. Mercer Capital often triangulates between different discount rate approaches, depending on the strength of available data. For example, we may consider (a) a weighted average cost of funding the loan, (b) market yields on traded instruments bearing similar risk, or (c) recent offering rates in the market for similar credit exposures.

Mercer Capital has developed fair value estimates for a wide variety of loan portfolios, on an exit price basis, ranging in size from under \$100 million to over \$1 billion, covering numerous lending niches, and possessing insignificant to severe asset quality deterioration. We have the resources, expertise, and experience to assist banks in complying with the new requirements in ASU 2016-01.

*Andrew K Gibbs*

**Andrew K. Gibbs, CFA, CPA/ABV**

901.322.9726

[gibbsa@mercercapital.com](mailto:gibbsa@mercercapital.com)

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**Jeff K. Davis, CFA**  
615.345.0350  
[jeffdavis@mercercapital.com](mailto:jeffdavis@mercercapital.com)

**Andrew K. Gibbs, CFA, CPA/ABV**  
901.322.9726  
[gibbsa@mercercapital.com](mailto:gibbsa@mercercapital.com)

**Jay D. Wilson, Jr., CFA, ASA, CBA**  
469.778.5860  
[wilsonj@mercercapital.com](mailto:wilsonj@mercercapital.com)

## MERCER CAPITAL

**Memphis**  
5100 Poplar Avenue, Suite 2600  
Memphis, Tennessee 38137  
901.685.2120

**Dallas**  
12201 Merit Drive, Suite 480  
Dallas, Texas 75251  
214.468.8400

**Nashville**  
102 Woodmont Blvd., Suite 231  
Nashville, Tennessee 37205  
615.345.0350

[www.mercercapital.com](http://www.mercercapital.com)