Case 11-2(b)

Fair Value Disclosures

Case 11-2(b) is an extension of Case 11-2(a). For this case, assume that the Case 11-2(a) facts remain, with the exception of the additional assumptions listed below for each security. As stated in Case 11-2(a), Family Finance Co. (FFC) accounts for its equity investments at fair value with changes in fair value reflected in earnings, and debt securities as either trading securities or available-for-sale (AFS) securities (with changes in fair value recorded through net income or other comprehensive income (OCI), respectively).[1,2] Because FFC uses the interest rate swap in a cash-flow hedge, FFC measures the derivative at fair value, presenting the portion of the fair value change that effectively offsets cash flow variability on its corporate debt in OCI and the remainder in earnings.[3]

Additional facts related to specific securities and derivatives owned by FFC are described below. Also refer to the data table at the end of this section for the fair value amounts for each instrument needed to complete the case.

Students should assume that all amounts discussed below and those included in the data tables are U.S. dollars in thousands.

Instrument 1 — Collateralized Debt Obligation

- FFC classifies its collateralized debt obligation (CDO) within Level 3 of the ASC 820, *Fair Value Measurement*, fair value hierarchy as of December 31, 20X2.
- FFC identified October 1, 20X2, as the date on which the CDO's fair value measurement changed in classification from Level 2 to Level 3.

[1] Note that as discussed in Case 11-2(a), Instrument 4 is an equity security that does not have a readily determinable fair value.

ASU 2016-01, *Recognition and Measurement of Financial Assets and Financial Liabilities*, updates the measurement guidance to require entities to carry all investments in equity securities, including other ownership interests such as partnerships, unincorporated joint ventures, and limited liability companies, at fair value through net income. This requirement does not apply to investments that qualify for the equity method of accounting or to those that result in consolidation of the investee or for which the entity has elected the practicability exception to fair value measurement. An entity is permitted to elect a practicability exception to fair value measurement, under which the investment will be measured at cost, less impairment, plus or minus observable price changes (in orderly transactions) of an identical or similar investment of the same issuer. As noted in the background to the case, the practical expedient was not elected for this investment.

[2] ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*, may have an impact on classification and measurement of these types of securities; however, the updated guidance will not affect the guidance relating to classification within the fair value hierarchy.

[3] The FASB's September 2016 proposed ASU, *Targeted Improvements to Accounting for Hedging Activities*, would require the earnings effect of the derivative be presented in the same income statement line item in which the earnings effect of the hedged item is presented; however, the updated guidance is not expected to affect the guidance relating to classification within the fair value hierarchy.

- FFC determined the broker quotes were not significant to the fair value measurement in its entirety because those quotes resulted in a management adjustment to the income-approach discount rate of just 1 percent. On the basis of sensitivity analysis performed by adjusting the discount rate, management determined percentage changes of 2 percent result in a significantly higher or lower fair value. Further, management performed a qualitative assessment of the significance of these inputs to its fair value measurement and concluded that it did not place much weight on these measurements because they were based on proprietary models using unobservable inputs. That is, management could not, without unreasonable effort, conclude with sufficient assurance whether the quotes were prepared in accordance with ASC 820 and reflected current market conditions and market participant assumptions.

- FFC accounts for the CDO as a trading security.

Instrument 2 — Mortgage-Backed Security

- FFC classifies its mortgage-backed security (MBS) within Level 2 of the fair value hierarchy as of December 31, 20X2.

- FFC accounts for the MBS as a trading security.

Instrument 3 — Auction-Rate Security

- FFC classifies its auction-rate securities (ARSs) within Level 3 of the fair value hierarchy as of December 31, 20X2.

- FFC identified November 1, 20X2, as the date on which the fair value measurement of the ARSs changed in classification from Level 2 to Level 3.

- FFC accounts for the ARSs as AFS securities.

Instrument 4 — Equity Security of a Nonpublic Company

- FFC classifies its investment in Company X within Level 3 of the fair value hierarchy during 20X2.

- FFC sold the equity security in October 20X2 for $120.

Instrument 5 — Interest Rate Swap

- The interest rate (IR) swap is part of a portfolio of IR swaps. FFC individually assessed the IR swaps and classified them within Level 2 of the fair value hierarchy as of December 31, 20X2.

- FFC does not measure its corporate debt at fair value with changes in fair value reported in earnings.

- FFC executes IR swaps with various counterparties and accounts for its IR swap assets and liabilities on a gross basis on its balance sheet.

Instrument 6 — Fuel Swap: Gasoline

- FFC classifies its fuel swap within Level 3 of the fair value hierarchy as of December 31, 20X2.
- The fuel swap was the only derivative in FFC's commodity derivatives portfolio.
- The fuel swap's fair value at initial recognition (January 2, 20X2) was $0. Furthermore, each of the four annual swaplets[4] had an inception value of $0.
- The first annual swaplet settled on December 31, 20X2, resulting in a net cash payment to FFC of $100.

Required:

- Using the case facts and the fair value amounts provided in the fair value data table below, prepare the annual quantitative disclosure tables required by ASC 820 as of December 31, 20X2, for each of the six instruments:
    - The fair value measurements as of the reporting date (i.e., December 31, 20X2) separately for each class of assets and liabilities. **Use blank table formats 1a and 1b below to complete the required quantitative disclosures**. (Note that participants are also required to identify the classes of assets and liabilities to include in Tables 1a and 1b.)
    - For assets and liabilities measured at fair value by means of significant unobservable inputs on a recurring basis, a reconciliation of the beginning and ending balances (i.e., annual table) separately for each class of assets and liabilities, including where the gains or losses included in earnings are reported in the income statement. **Use blank table format 2 below to complete the required quantitative disclosures**. (Note that participants are also required to identify the classes of assets and liabilities to include in Table 2.)
    - For certain assets and liabilities measured at fair value, (1) the amount of the total gains or losses for the period included in earnings that are attributable to the change in unrealized gains or losses relating to those assets and liabilities still held as of the reporting date (i.e., December 31, 20X2) and (2) a description of where those unrealized gains or losses are reported in the income statement. **Use blank table format 2 below to complete the required quantitative disclosures**.
    - For assets and liabilities measured at fair value by means of significant unobservable inputs, quantitative information about the significant

[4] A swaplet is akin to a swap with a single settlement. For example, an IR swap with a duration of two years that re-prices and settles every quarter can also be viewed as a sequential series of eight swaplets at inception (each swaplet is net settled as of the settlement date specified in the swap contract). The fair value measurement of an IR swap considers the expected cash flows of all unsettled swaplets as of the measurement date.

unobservable inputs used in the fair value measurement. **Use blank table format 3 below to complete the required quantitative disclosures.** (Note that participants are also required to identify the classes of assets and liabilities to include in Table 3.)

- Identify any qualitative disclosures required under ASC 820 for each of the six instruments as of December 31, 20X2.

Data Tables

Fair Value Data Table

(U.S. dollar amounts in thousands)

Instrument	Beginning Balance — 1/1/20X2	Purchase Value / Date	Fair Value at Transfer Date	Ending Balance — 12/31/20X2	Income Statement Line Item
1. CDO	N/A	50 / 6/1/X2	40	25	Trading revenues
2. MBS	N/A	85 / 9/1/X2	N/A	75	Trading revenues
3. ARS	75	N/A	55	50	Other revenues
4. Equity security of nonpublic company (PEI)	90	N/A	N/A	0	Other revenues
5. IR swap (asset)	N/A	0 / 1/2/20X2	N/A	40	Interest Expense
5a. IR swap portfolio — gross asset values	200	Various	N/A	140	Same as 5
5b. IR swap portfolio — gross liability values	(125)	Various	N/A	(100)	Same as 5
5c. IR swap portfolio — net assets by counterparty	105	Various	N/A	60	Same as 5
5d. IR swap portfolio — net liability by counterparty	(30)	Various	N/A	(20)	Same as 5
6. Fuel swap	N/A	0 / 1/2/20X2	N/A	375	Trading revenues

PEI = private equity investments.

Instrument 5 — IR Swap Portfolio (Support for Break-up by Counterparty to Compute Gross Values)

		Counterparties			
Beginning Balance	**Total**	**A-1**	**A-2**	**B-1**	**B-2**
Asset	200	20	40	20	120
Liability	–125	–30	–25	–40	–30
Net	75	–10	15	–20	90
Ending balance					
Asset	140	40	50	30	20
Liability	–100	–15	–15	–50	–20
Net	40	25	35	–20	0

Fuel Swap Data Table							
Pay Fixed, Receive Float (Fuel Swap)							
Four-year swap settles annually, executed 1/1/X2, matures 12/31/X5; Inception transaction price = zero (at-market swap), each of the four annual swaplets had an inception fair value = zero							
Fair Value by Period by Swaplet	**Swaplet Fair Value**					**Cash Flow From Settlements Occurring at End of Quarter**	
	Year 1	Year 2	Year 3	Year 4	Total		
Fair value — Year 1 (1/2/X2 — beginning of period)	0	0	0	0	0		
Fair value — Year 1 (12/31/X2 — end of period)	N/A — settled	120	125	130	375	Y1	100

Unobservable Inputs Data Table	
Collateralized Debt Obligation	
Credit spread	2%
Discount for lack of marketability	5%
Aucton-Rate Security	
Estimate of future coupon rates	4.30%
Constant prepayment rate	4.00%
Credit spread	2.00%
Discount for lack of marketability	15%
Aucton-Rate Security	
U.S. unleaded gasoline forward price curve (per gallon)	$2.00 - $4.00
CVA	4.00%

Format for Table 1a:

Table 1a			
Description / Classes [For Assets]	Fair Value Measurements as of Reporting Date Determined by		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
[CLASSES TO BE DETERMINED			
BY PARTICIPANTS]			
Total assets	–	–	–

Format for Table 1b:

Table 1b			
Description / Classes [For Liabilities]	Fair Value Measurements as of Reporting Date Determined by		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
[CLASSES TO BE DETERMINED			
BY PARTICIPANTS]			
Total liabilities			

Format for Table 2:

Level 3 Recurring Fair Value Measurement Disclosure	Trading CDO	AFS ARS	PEI Retail	Derivatives Commodities
Beginning balance				
Total gains or losses (realized/unrealized):				
Included in earnings (or changes in net assets)				
Included in other comprehensive income				
Purchases				
Issues				
Sales				
Settlements				
Transfers into Level 3				
Transfers out of Level 3				
Ending balance				
The amount of total gains or losses for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held as of the reporting date				
Realized				
Total				

Format for Table 3:

Level 3 Fair Value Measurements - Quantitative Information About Significant Unobservable Inputs

Investment	Fair Value at 12/31/12	Valuation Technique	Unobservable Input	Value
Instrument 1	Fair Value	Technique	Input 1	Amount, range, etc.
			Input 2	Amount, range, etc.
Instrument 2	Fair Value	Technique	Input 1	Amount, range, etc.