**OXFORD INVESTMENT GROUP**

Delta Bank and Trust was heavily involved in making home loans during the housing boom. Initially Delta held the loans until maturity. However, as the boom gradually increased over the past two decades Delta packaged the loans and sold them to investors. At first they held the loans for 5-7 years before packaging and selling them to investors. But as the boom continued it got to the point where they were bundling the loans and selling them off about every ninety days. This process was the only way that Delta could obtain the necessary loanable funds rapidly enough to serve the next borrower (home buyer).

The bundled loans were sold in the marketplace as Collateralized Debt Obligations (CDOs). The CDOs were given the highest rating by the New York debt rating agencies. Oxford Investment Group made the decision to invest heavily into the highly rated CDOs. Oxford purchased $10,000,000 face value of Delta Bank and Trust CDOs for $9,000,000 in late December of 20X8. The securities were reported on the balance sheet at the fair value using Level 1 inputs which in this case was the same as the acquisition cost of $9,000,000.

About three-quarters of the way through 20X9 the financial crisis hit. The market value of CDOs dropped to five percent of face value. This meant that Oxford’s investment in CDOs at the end of 20X9 now had a fair market value based on Level 1 inputs of $500,000. This value would result in a recognized loss of $8,500,000.

Oxford’s controller, a former Big 4 partner, opted to value the CDOs using Level 3 inputs at the end of 20X9 instead of Level 1 inputs. Level 3 inputs placed the value of the CDOs at $7,500,000 using a discounted cash flow model. However, Oxford’s auditors, Jwoow, Snooki, and Situation, CPAs, argued that Oxford should continue to value the CDOs using Level 1 inputs. This would mean that Oxford would need to write-down the CDOs to $500,000 and take a loss of $8,500,000 instead of $1,500,000. The president of Oxford has argued that the CDOs are debt securities that qualify as held-to-maturity securities. As such, the CDOs should be accounted for using amortized cost and not adjusted to fair value. This would mean that the CDOs should be written up by the amount of the amortization of the difference between the face value and the acquisition cost and not written down.

REQUIRED:

1. What are Level 1, Level 2, and Level 3 inputs?
2. Is it possible for a security being valued using Level 1 inputs in one year to be valued using Level 3 inputs in a subsequent year?
3. At what amount should the CDOs be valued at the end of 20X9? Justify your answer based on U.S. GAAP.