First American Financial Corp
Form 10-Q
October 20, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

OR

1 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______

Commission file number 001-34580

FIRST AMERICAN FINANCIAL CORPORATION

(Exact name of registrant as specified in its charter)

Incorporated in Delaware (State or other jurisdiction of incorporation or organization)	26-1911571 (I.R.S. Employer Identification No.)
1 First American Way, Santa Ana, California (Address of principal executive offices)	92707-5913 (Zip Code)

(714) 250-3000

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No 1

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No 1

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer 1
Non-accelerated filer 1 (Do not check if a smaller reporting company)	Smaller reporting company 1

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes 1 No

APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY

PROCEEDINGS DURING THE PRECEDING FIVE YEARS:

Indicate by check mark whether the registrant has filed all documents and reports to be filed by Section 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court. Yes 1 No 1

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

On October 14, 2016, there were 109,820,934 shares of common stock outstanding.

FIRST AMERICAN FINANCIAL CORPORATION

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INFORMATION INCLUDED IN REPORT

Items 2 through 5 of Part II have been omitted because they are not applicable with respect to the current reporting period.

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THIS QUARTERLY REPORT ON FORM 10-Q CONTAINS FORWARD-LOOKING STATEMENTS WITHIN THE MEANING OF SECTION 27A OF THE SECURITIES ACT OF 1933, AS AMENDED, AND SECTION 21E OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED. THESE FORWARD-LOOKING STATEMENTS CAN BE IDENTIFIED BY THE FACT THAT THEY DO NOT RELATE STRICTLY TO HISTORICAL OR CURRENT FACTS AND MAY CONTAIN THE WORDS "BELIEVE," "ANTICIPATE," "EXPECT," "INTEND," "PLAN," "PREDICT," "ESTIMATE," "PROJECT," "WILL BE," "WILL CONTINUE," "WILL LIKELY RESU OTHER SIMILAR WORDS AND PHRASES OR FUTURE OR CONDITIONAL VERBS SUCH AS "WILL," "MAY," "MIGHT," "SHOULD," "WOULD," OR "COULD." THESE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION, STATEMENTS REGARDING FUTURE OPERATIONS, PERFORMANCE, FINANCIAL CONDITION, PROSPECTS, PLANS AND STRATEGIES. THESE FORWARD-LOOKING STATEMENTS ARE BASED ON CURRENT EXPECTATIONS AND ASSUMPTIONS THAT MAY PROVE TO BE INCORRECT.

RISKS AND UNCERTAINTIES EXIST THAT MAY CAUSE RESULTS TO DIFFER MATERIALLY FROM THOSE SET FORTH IN THESE FORWARD-LOOKING STATEMENTS. FACTORS THAT COULD CAUSE THE ANTICIPATED RESULTS TO DIFFER FROM THOSE DESCRIBED IN THE FORWARD-LOOKING STATEMENTS INCLUDE, WITHOUT LIMITATION:

- INTEREST RATE FLUCTUATIONS;
- CHANGES IN THE PERFORMANCE OF THE REAL ESTATE MARKETS;
- VOLATILITY IN THE CAPITAL MARKETS;
- UNFAVORABLE ECONOMIC CONDITIONS;
- IMPAIRMENTS IN THE COMPANY'S GOODWILL OR OTHER INTANGIBLE ASSETS;
- FAILURES AT FINANCIAL INSTITUTIONS WHERE THE COMPANY DEPOSITS FUNDS;
- CHANGES IN APPLICABLE GOVERNMENT REGULATIONS;
- HEIGHTENED SCRUTINY BY LEGISLATORS AND REGULATORS OF THE COMPANY'S TITLE INSURANCE AND SERVICES SEGMENT AND CERTAIN OTHER OF THE COMPANY'S BUSINESSES;
- THE CONSUMER FINANCIAL PROTECTION BUREAU'S EXERCISE OF ITS BROAD RULEMAKING AND SUPERVISORY POWERS;
- REGULATION OF TITLE INSURANCE RATES;
- REFORM OF GOVERNMENT-SPONSORED MORTGAGE ENTERPRISES;
- LIMITATIONS ON ACCESS TO PUBLIC RECORDS AND OTHER DATA;
- CHANGES IN RELATIONSHIPS WITH LARGE MORTGAGE LENDERS AND GOVERNMENT-SPONSORED ENTERPRISES;
- CHANGES IN MEASURES OF THE STRENGTH OF THE COMPANY'S TITLE INSURANCE UNDERWRITERS, INCLUDING RATINGS AND STATUTORY CAPITAL AND SURPLUS;
- LOSSES IN THE COMPANY'S INVESTMENT PORTFOLIO;
- MATERIAL VARIANCE BETWEEN ACTUAL AND EXPECTED CLAIMS EXPERIENCE;
- DEFALCATIONS, INCREASED CLAIMS OR OTHER COSTS AND EXPENSES ATTRIBUTABLE TO THE COMPANY'S USE OF TITLE AGENTS;
- ANY INADEQUACY IN THE COMPANY'S RISK MITIGATION EFFORTS;
- SYSTEMS DAMAGE, FAILURES, INTERRUPTIONS AND INTRUSIONS, OR UNAUTHORIZED DATA DISCLOSURES;
- ERRORS AND FRAUD INVOLVING THE TRANSFER OF FUNDS;
- INABILITY TO REALIZE THE BENEFITS OF THE COMPANY'S OFFSHORE OPERATIONS;
- INABILITY OF THE COMPANY'S SUBSIDIARIES TO PAY DIVIDENDS OR REPAY FUNDS;

- INABILITY TO REALIZE THE BENEFITS OF, AND CHALLENGES ARISING FROM, THE COMPANY'S ACQUISITION STRATEGY; AND
- OTHER FACTORS DESCRIBED IN THIS QUARTERLY REPORT ON FORM 10-Q, INCLUDING UNDER THE CAPTION "RISK FACTORS" IN ITEM 1A OF PART II.

THE FORWARD-LOOKING STATEMENTS SPEAK ONLY AS OF THE DATE THEY ARE MADE. THE COMPANY DOES NOT UNDERTAKE TO UPDATE FORWARD-LOOKING STATEMENTS TO REFLECT CIRCUMSTANCES OR EVENTS THAT OCCUR AFTER THE DATE THE FORWARD-LOOKING STATEMENTS ARE MADE.

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements.
FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Balance Sheets

(in thousands, except par values)

(unaudited)

	September 30, 2016	December 31, 2015
Assets		
Cash and cash equivalents	$1,443,312	$1,027,321
Accounts and accrued income receivable, net	327,109	256,731
Income taxes receivable	2,740	1,067
Investments:		
Deposits with banks	22,257	23,224
Debt securities, includes pledged securities of $117,294 and $122,441	4,592,170	4,279,347
Equity securities	387,921	321,285
Other investments	157,260	161,177
	5,159,608	4,785,033
Property and equipment, net	430,631	409,973
Title plants and other indexes	588,593	554,923
Deferred income taxes	22,020	22,020
Goodwill	1,014,764	964,342
Other intangible assets, net	51,417	48,114
Other assets	206,283	180,777
	$9,246,477	$8,250,301
Liabilities and Equity		
Deposits	$3,218,128	$2,699,015
Accounts payable and accrued liabilities	813,943	876,087
Deferred revenue	230,747	207,929
Reserve for known and incurred but not reported claims	1,018,040	983,880
Income taxes payable	66,025	7,576
Deferred income taxes	133,097	133,097
Notes and contracts payable	737,944	581,052
	6,217,924	5,488,636
Commitments and contingencies (Note 14)		
Stockholders’ equity:		
Preferred stock, $0.00001 par value; Authorized—500 shares; Outstanding—none	—	—

Common stock, $0.00001 par value; Authorized—300,000 shares;		
Outstanding—109,820 shares and 109,098 shares	1	1
Additional paid-in capital	2,182,879	2,150,813
Retained earnings	1,012,452	846,691
Accumulated other comprehensive loss	(173,052)	(239,003)
Total stockholders' equity	3,022,280	2,758,502
Noncontrolling interests	6,273	3,163
Total equity	3,028,553	2,761,665
	$9,246,477	$8,250,301

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Income

(in thousands, except per share amounts)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenues				
Direct premiums and escrow fees	$649,726	$605,450	$1,775,615	$1,716,468
Agent premiums	625,953	585,974	1,653,990	1,520,507
Information and other	188,727	173,349	526,575	511,334
Net investment income	34,422	22,272	92,717	70,694
Net realized investment gains (losses)	9,516	(3,130)	22,692	(215)
	1,508,344	1,383,915	4,071,589	3,818,788
Expenses				
Personnel costs	438,692	411,743	1,239,129	1,185,318
Premiums retained by agents	495,130	462,535	1,303,838	1,200,549
Other operating expenses	219,959	209,316	622,995	621,298
Provision for policy losses and other claims	137,015	139,126	366,473	363,550
Depreciation and amortization	24,491	21,072	70,905	63,389
Premium taxes	18,288	17,439	48,692	46,920
Interest	7,838	7,288	23,427	21,798
	1,341,413	1,268,519	3,675,459	3,502,822
Income before income taxes	166,931	115,396	396,130	315,966
Income taxes	59,539	39,637	133,615	108,831
Net income	107,392	75,759	262,515	207,135
Less: Net income attributable to noncontrolling interests	72	217	545	615
Net income attributable to the Company	$107,320	$75,542	$261,970	$206,520
Net income per share attributable to the Company's stockholders (Note 9):				
Basic	$0.97	$0.69	$2.37	$1.91
Diluted	$0.96	$0.69	$2.36	$1.88
Cash dividends declared per share	$0.34	$0.25	$0.86	$0.75
Weighted-average common shares outstanding (Note 9):				
Basic	110,571	108,647	110,423	108,284
Diluted	111,251	110,004	111,006	109,706

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Comprehensive Income

(in thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$107,392	$75,759	$262,515	$207,135
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities	2,579	(10,942)	52,087	(19,374)
Foreign currency translation adjustment	(3,459)	(15,416)	3,066	(29,210)
Pension benefit adjustment	3,602	4,058	10,819	13,260
Total other comprehensive income (loss), net of tax	2,722	(22,300)	65,972	(35,324)
Comprehensive income	110,114	53,459	328,487	171,811
Less: Comprehensive income attributable to noncontrolling interests	77	206	566	598
Comprehensive income attributable to the Company	$110,037	$53,253	$327,921	$171,213

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statement of Stockholders' Equity

(in thousands)

(unaudited)

	First American Financial Corporation Stockholders							
	Shares	Common stock	Additional paid-in capital	Retained earnings	Accumulated other comprehensive loss	Total stockholders' equity	Noncontrolling interests	Total
Balance at December 31, 2015	109,098	$1	$2,150,813	$846,691	$(239,003)	$2,758,502	$3,163	$2,761,665
Net income for nine months ended September 30, 2016	—	—	—	261,970	—	261,970	545	262,515
Dividends on common shares	—	—	—	(94,202)	—	(94,202)	—	(94,202)
Purchase of Company shares	(14)	—	(454)	—	—	(454)	—	(454)
Shares issued in connection with share-based compensation plans	736	—	4,450	(2,007)	—	2,443	—	2,443
Share-based compensation	—	—	28,096	—	—	28,096	—	28,096
Net activity related to noncontrolling interests	—	—	(26)	—	—	(26)	2,544	2,518
Other comprehensive income (Note 13)	—	—	—	—	65,951	65,951	21	65,972
Balance at September 30, 2016	109,820	$1	$2,182,879	$1,012,452	$(173,052)	$3,022,280	$6,273	$3,028,553

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Nine Months Ended September 30, 2016	2015
Cash flows from operating activities:		
Net income	$262,515	$207,135
Adjustments to reconcile net income to cash provided by operating activities:		
Provision for policy losses and other claims	366,473	363,550
Depreciation and amortization	70,905	63,389
Amortization of premiums and accretion of discounts on debt securities, net	20,267	21,702
Excess tax benefits from share-based compensation	(3,197)	(8,496)
Net realized investment (gains) losses	(22,692)	215
Share-based compensation	28,096	20,261
Equity in earnings of affiliates, net	(5,771)	(7,710)
Dividends from equity method investments	7,953	7,559
Changes in assets and liabilities excluding effects of acquisitions and noncash transactions:		
Claims paid, including assets acquired, net of recoveries	(351,349)	(364,255)
Net change in income tax accounts	20,765	56,784
Increase in accounts and accrued income receivable	(43,454)	(32,194)
Decrease in accounts payable and accrued liabilities	(99,777)	(7,074)
Increase in deferred revenue	23,342	12,049
Other, net	(21,857)	19,282
Cash provided by operating activities	252,219	352,197
Cash flows from investing activities:		
Net cash effect of acquisitions/dispositions	(73,173)	(26,662)
Net decrease in deposits with banks	608	2,471
Purchases of debt and equity securities	(1,490,824)	(1,726,939)
Proceeds from sales of debt and equity securities	494,717	443,276
Proceeds from maturities of debt securities	744,411	531,440
Net change in other investments	2,798	470
Capital expenditures	(103,735)	(91,964)
Proceeds from sales of property and equipment	9,218	17,057
Cash used for investing activities	(415,980)	(850,851)
Cash flows from financing activities:		
Net change in deposits	519,113	288,495
Net proceeds from issuance of debt	160,000	—
Repayment of debt	(3,745)	(4,087)

Net activity related to noncontrolling interests	(1,004)	(705)
Excess tax benefits from share-based compensation	3,197	8,496
Net payments in connection with share-based compensation plans	(754)	(1,534)
Purchase of Company shares	(454)	—
Cash dividends	(94,202)	(81,283)
Cash provided by financing activities	582,151	209,382
Effect of exchange rate changes on cash	(2,399)	(6,378)
Net increase (decrease) in cash and cash equivalents	415,991	(295,650)
Cash and cash equivalents—Beginning of period	1,027,321	1,190,080
Cash and cash equivalents—End of period	$1,443,312	$894,430
Supplemental information:		
Cash paid during the period for:		
Interest	$21,097	$21,166
Premium taxes	$54,151	$45,683
Income taxes, less refunds of $2,731 and $711	$112,401	$52,069

See notes to condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements

(unaudited)

Note 1 – Basis of Condensed Consolidated Financial Statements

Basis of Presentation

The condensed consolidated financial information included in this report has been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information and Article 10 of Securities and Exchange Commission ("SEC") Regulation S-X. The principles for condensed interim financial information do not require the inclusion of all the information and footnotes required by GAAP for complete financial statements. Therefore, these financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2015. The condensed consolidated financial statements included herein are unaudited; however, in the opinion of management, they contain all normal recurring adjustments necessary for a fair statement of the consolidated results for the interim periods. All material intercompany transactions and balances have been eliminated upon consolidation.

Reclassifications and revisions

Certain 2015 amounts have been reclassified to conform to the 2016 presentation.

During the fourth quarter of 2015, the Company reclassified certain revenues and expenses related to closing protection letters and temporary labor costs. The impact to the Company's title insurance and services segment for the three and nine months ended September 30, 2015 included decreases to direct premiums and escrow fees and increases to agent premiums of $9.5 million and $24.6 million, increases to personnel costs of $10.6 million and $29.0 million, increases to premiums retained by agents of $0.5 million and $1.2 million and decreases to other operating expenses of $11.1 million and $30.2 million, respectively. The impact to the Company's specialty insurance segment for the three and nine months ended September 30, 2015 included increases to personnel costs and decreases to other operating expenses of $0.2 million and $0.7 million, respectively.

Also, during the fourth quarter of 2015, the Company identified certain non-risk based revenues included within direct premiums and escrow fees that should have been reflected in information and other. To correct for this error, these revenues were reclassified from direct premiums and escrow fees to information and other. The revision to the Company's title insurance and services segment for the three and nine months ended September 30, 2015 resulted in a decrease to direct premiums and escrow fees and an increase to information and other of $10.7 million and $31.5 million, respectively.

The Company does not consider these adjustments to be material, individually or in the aggregate, to any previously issued consolidated financial statements.

Recently Adopted Accounting Pronouncements

In September 2015, the Financial Accounting Standards Board ("FASB") issued updated guidance intended to simplify the accounting for adjustments made to provisional amounts recognized in a business combination and eliminates the requirement to retrospectively account for those adjustments. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015 and applies prospectively to adjustments made to provisional amounts that occur after the effective date of this guidance with early adoption permitted for financial statements that have not been issued. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In August 2015, the FASB issued updated guidance relating to the Securities and Exchange Commission Staff Announcement at the June 18, 2015 Emerging Issues Task Force meeting on the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements. The updated guidance allows for the deferral and presentation of debt issuance costs as an asset which may be amortized ratably over the term of the line-of-credit arrangement, regardless of whether there are any related outstanding borrowings. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

In May 2015, the FASB issued updated guidance intended to eliminate the diversity in practice surrounding how investments measured at net asset value under the practical expedient with future redemption dates have been categorized in the fair value hierarchy. Under the updated guidance, investments for which fair value is measured at net asset value per share using the practical expedient should no longer be categorized in the fair value hierarchy. The updated guidance requires retrospective adoption for all periods presented and is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In April 2015, the FASB issued updated guidance intended to clarify the accounting treatment for cloud computing arrangements that include software licenses. Under the updated guidance, if a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The Company elected to adopt the updated guidance prospectively for all arrangements entered into or materially modified after the effective date. The adoption of this guidance did not have a material impact on the Company's condensed consolidated financial statements. The financial statement line items impacted by the adoption of the updated guidance include other intangible assets, net and depreciation and amortization. See Note 5 Other Intangible Assets for further information on the Company's internal-use software licenses.

In April 2015, the FASB issued updated guidance intended to simplify, and provide consistency to, the presentation of debt issuance costs. The new standard requires that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with debt discounts. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance did not have a material impact on the Company's condensed consolidated financial statements.

In February 2015, the FASB issued updated guidance which changes the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

In June 2014, the FASB issued updated guidance intended to eliminate the diversity in practice regarding share-based payment awards that include terms which provide for a performance target that affects vesting being achieved after the requisite service period. The new standard requires that a performance target which affects vesting and could be achieved after the requisite service period be treated as a performance condition that affects vesting and should not be reflected in estimating the grant-date fair value. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2015, with early adoption permitted. The adoption of this guidance had no impact on the Company's condensed consolidated financial statements.

Pending Accounting Pronouncements

In August 2016, the FASB issued updated guidance intended to eliminate the diversity in practice regarding the presentation and classification of certain cash receipts and cash payments in the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated statement of cash flows.

In June 2016, the FASB issued updated guidance intended to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The updated guidance replaces the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires the consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2019, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

FIRST AMERICAN FINANCIAL CORPORATION

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Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

In May 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance includes narrow-scope improvements intended to address implementation issues and to provide additional practical expedients in the guidance. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In April 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance is intended to reduce the cost and complexity of applying the guidance on identifying promised goods or services in a contract and to improve the operability and understandability of the implementation guidance regarding the licensing of intellectual property. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to simplify and improve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of such awards as either equity or liabilities and classification on the statement of cash flows. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to clarify the guidance previously issued in May 2014 related to the recognition of revenue from contracts with customers. The updated guidance is intended to improve the operability and understandability of the implementation guidance regarding principal versus agent considerations in a contract. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted for interim and annual reporting periods beginning after December 15, 2016. The Company does not expect the adoption of this guidance to have a material impact on its condensed consolidated financial statements.

In March 2016, the FASB issued updated guidance intended to simplify the accounting treatment for investments that become qualified for the equity method of accounting as a result of an increase in the level of ownership interest or degree of influence. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption permitted. The Company expects the adoption of this guidance to have no impact on its condensed consolidated financial statements.

In February 2016, the FASB issued updated guidance that requires the rights and obligations associated with leasing arrangements be reflected on the balance sheet in order to increase transparency and comparability among organizations. Under the updated guidance, lessees will be required to recognize a right-of-use asset and a liability to make lease payments and disclose key information about leasing arrangements. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2018, with early adoption permitted. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

In January 2016, the FASB issued updated guidance intended to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. In addition to making other targeted improvements to current guidance, the updated guidance also requires all equity investments, except those accounted for under the equity method of accounting or those that result in consolidation of the investee, to be measured at fair value with changes in the fair value recognized through net income. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted in certain circumstances. While the Company expects the adoption of this guidance to impact its condensed consolidated statements of income, the materiality of the impact will depend upon the size of, and level of volatility experienced within, the Company’s equity portfolio.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

In May 2015, the FASB issued updated disclosure guidance related to short-duration contracts issued by insurance entities. The updated guidance is intended to increase the transparency of significant estimates made in measuring liabilities for unpaid claims and claim adjustment expenses and to provide additional insight into an insurance entity's ability to underwrite and anticipate costs associated with claims. The updated guidance is effective for annual reporting periods beginning after December 15, 2015 and for interim periods within annual periods beginning after December 15, 2016, with early adoption permitted. Except for the disclosure requirements, the Company does not expect the adoption of this guidance to impact its condensed consolidated financial statements.

In May 2014, the FASB issued updated guidance for recognizing revenue from contracts with customers to provide a single, comprehensive revenue recognition model for all contracts with customers to improve comparability within and across industries, and across capital markets. The new revenue standard contains principles that an entity will apply to determine the measurement of revenue and the timing of recognition. The underlying principle is that an entity will recognize revenue to depict the transfer of goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. Revenue from insurance contracts is not within the scope of this guidance. The updated guidance is effective for interim and annual reporting periods beginning after December 15, 2016, with early adoption prohibited. In August 2015, the FASB issued updated guidance which defers the effective date of this guidance by one year to interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted as of the original effective date. The Company is currently assessing the impact of the new guidance on its condensed consolidated financial statements.

Note 2 – Escrow Deposits, Like-kind Exchange Deposits and Trust Assets

The Company administers escrow deposits and trust assets as a service to its customers. Escrow deposits totaled $7.5 billion and $6.6 billion at September 30, 2016 and December 31, 2015, respectively, of which $3.1 billion and $2.6 billion, respectively, were held at the Company's federal savings bank subsidiary, First American Trust, FSB. The escrow deposits held at First American Trust, FSB are temporarily invested in cash and cash equivalents and debt securities, with offsetting liabilities included in deposits in the accompanying condensed consolidated balance sheets. The remaining escrow deposits were held at third-party financial institutions.

Trust assets held or managed by First American Trust, FSB totaled $3.2 billion and $3.0 billion at September 30, 2016 and December 31, 2015, respectively. Escrow deposits held at third-party financial institutions and trust assets are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. However, the Company could be held contingently liable for the disposition of these assets.

In conducting its operations, the Company often holds customers' assets in escrow, pending completion of real estate transactions and, as a result, the Company has ongoing programs for realizing economic benefits with various financial institutions. The results from these programs are included in the condensed consolidated financial statements as income or a reduction in expense, as appropriate, based on the nature of the arrangement and benefit received.

The Company facilitates tax-deferred property exchanges for customers pursuant to Section 1031 of the Internal Revenue Code and tax-deferred reverse exchanges pursuant to Revenue Procedure 2000-37. As a facilitator and intermediary, the Company holds the proceeds from sales transactions and takes temporary title to property identified by the customer to be acquired with such proceeds. Upon the completion of each such exchange, the identified property is transferred to the customer or, if the exchange does not take place, an amount equal to the sales proceeds or, in the case of a reverse exchange, title to the property held by the Company is transferred to the customer. Like-kind exchange funds held by the Company totaled $2.2 billion and $2.8 billion at September 30, 2016 and December 31, 2015, respectively. The like-kind exchange deposits are held at third-party financial institutions and, due to the structure utilized to facilitate these transactions, the proceeds and property are not considered assets of the Company and, therefore, are not included in the accompanying condensed consolidated balance sheets. All such amounts are placed in deposit accounts insured, up to applicable limits, by the Federal Deposit Insurance Corporation. The Company could be held contingently liable to the customer for the transfers of property, disbursements of proceeds and the returns on such proceeds.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Note 3 – Debt and Equity Securities

Investments in debt securities, classified as available-for-sale, are as follows:

(in thousands)	Amortized cost	Gross unrealized Gains	Gross unrealized Losses	Estimated fair value
September 30, 2016				
U.S. Treasury bonds	$148,808	$2,089	$(463)	$150,434
Municipal bonds	906,895	19,565	(2,223)	924,237
Foreign government bonds	143,853	1,847	(342)	145,358
Governmental agency bonds	192,430	2,870	(123)	195,177
Governmental agency mortgage-backed securities	2,229,651	12,309	(6,163)	2,235,797
U.S. corporate debt securities	674,651	17,722	(1,635)	690,738
Foreign corporate debt securities	245,227	5,665	(463)	250,429
	$4,541,515	$62,067	$(11,412)	$4,592,170
December 31, 2015				
U.S. Treasury bonds	$130,252	$421	$(1,301)	$129,372
Municipal bonds	692,000	12,640	(845)	703,795
Foreign government bonds	129,984	1,132	(1,015)	130,101
Governmental agency bonds	419,869	1,023	(2,801)	418,091
Governmental agency mortgage-backed securities	2,065,728	4,984	(15,039)	2,055,673
U.S. corporate debt securities	642,869	4,297	(12,483)	634,683
Foreign corporate debt securities	210,162	1,248	(3,778)	207,632
	$4,290,864	$25,745	$(37,262)	$4,279,347

Investments in equity securities, classified as available-for-sale, are as follows:

(in thousands)	Cost	Gross unrealized Gains	Gross unrealized Losses	Estimated fair value
September 30, 2016				
Preferred stocks	$19,311	$—	$(4,092)	$15,219
Common stocks	351,841	24,742	(3,881)	372,702
	$371,152	$24,742	$(7,973)	$387,921
December 31, 2015				
Preferred stocks	$18,305	$420	$(3,258)	$15,467
Common stocks	307,429	13,103	(14,714)	305,818
	$325,734	$13,523	$(17,972)	$321,285

Sales of debt and equity securities resulted in realized gains of $8.9 million and $1.3 million and realized losses of $0.2 million and $1.6 million for the three months ended September 30, 2016 and 2015, respectively, and realized gains of $22.1 million and $6.5 million and realized losses of $7.2 million and $8.2 million for the nine months ended September 30, 2016 and 2015, respectively.

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Gross unrealized losses on investments in debt and equity securities are as follows:

	Less than 12 months		12 months or longer		Total	
(in thousands)	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses	Estimated fair value	Unrealized losses
September 30, 2016						
Debt securities:						
U.S. Treasury bonds	$55,705	$(463)	$—	$—	$55,705	$(463)
Municipal bonds	223,714	(1,941)	16,401	(282)	240,115	(2,223)
Foreign government bonds	32,714	(313)	363	(29)	33,077	(342)
Governmental agency bonds	5,706	(123)	—	—	5,706	(123)
Governmental agency mortgage-backed securities	749,900	(2,654)	339,896	(3,509)	1,089,796	(6,163)
U.S. corporate debt securities	50,855	(634)	30,740	(1,001)	81,595	(1,635)
Foreign corporate debt securities	21,121	(181)	9,990	(282)	31,111	(463)
Total debt securities	1,139,715	(6,309)	397,390	(5,103)	1,537,105	(11,412)
Equity securities	7,716	(74)	76,717	(7,899)	84,433	(7,973)
Total	$1,147,431	$(6,383)	$474,107	$(13,002)	$1,621,538	$(19,385)
December 31, 2015						
Debt securities:						
U.S. Treasury bonds	$105,701	$(1,285)	$1,654	$(16)	$107,355	$(1,301)
Municipal bonds	133,465	(733)	13,190	(112)	146,655	(845)
Foreign government bonds	13,601	(890)	267	(125)	13,868	(1,015)
Governmental agency bonds	191,035	(2,497)	18,237	(304)	209,272	(2,801)
Governmental agency mortgage-backed securities	1,096,301	(9,424)	213,020	(5,615)	1,309,321	(15,039)
U.S. corporate debt securities	361,842	(11,272)	13,511	(1,211)	375,353	(12,483)
Foreign corporate debt securities	102,801	(2,725)	11,246	(1,053)	114,047	(3,778)
Total debt securities	2,004,746	(28,826)	271,125	(8,436)	2,275,871	(37,262)
Equity securities	191,248	(12,068)	31,974	(5,904)	223,222	(17,972)
Total	$2,195,994	$(40,894)	$303,099	$(14,340)	$2,499,093	$(55,234)

FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

Investments in debt securities at September 30, 2016, by contractual maturities, are as follows:

(in thousands)	Due in one year or less	Due after one through five years	Due after five through ten years	Due after ten years	Total
U.S. Treasury bonds					
Amortized cost	$ 35,270	$ 68,799	$ 16,147	$ 28,592	$ 148,808
Estimated fair value	$ 35,293	$ 69,127	$ 16,660	$ 29,354	$ 150,434
Municipal bonds					
Amortized cost	$ 47,544	$ 331,550	$ 214,529	$ 313,272	$ 906,895
Estimated fair value	$ 47,615	$ 337,258	$ 221,613	$ 317,751	$ 924,237
Foreign government bonds					
Amortized cost	$ 4,447	$ 107,304	$ 11,240	$ 20,862	$ 143,853
Estimated fair value	$ 4,482	$ 108,323	$ 11,702	$ 20,851	$ 145,358
Governmental agency bonds					
Amortized cost	$ 20,771	$ 82,989	$ 47,203	$ 41,467	$ 192,430
Estimated fair value	$ 20,781	$ 83,238	$ 47,561	$ 43,597	$ 195,177
U.S. corporate debt securities					
Amortized cost	$ 15,513	$ 318,116	$ 274,598	$ 66,424	$ 674,651
Estimated fair value	$ 15,578	$ 324,386	$ 281,216	$ 69,558	$ 690,738
Foreign corporate debt securities					
Amortized cost	$ 9,521	$ 114,704	$ 110,180	$ 10,822	$ 245,227
Estimated fair value	$ 9,532	$ 116,436	$ 112,776	$ 11,685	$ 250,429
Total debt securities excluding mortgage-backed securities					
Amortized cost	$ 133,066	$ 1,023,462	$ 673,897	$ 481,439	$ 2,311,864
Estimated fair value	$ 133,281	$ 1,038,768	$ 691,528	$ 492,796	$ 2,356,373
Total mortgage-backed securities					
Amortized cost					$ 2,229,651
Estimated fair value					$ 2,235,797
Total debt securities					
Amortized cost					$ 4,541,515
Estimated fair value					$ 4,592,170

Mortgage-backed securities, which include contractual terms to maturity, are not categorized by contractual maturity because borrowers may have the right to call or prepay obligations with, or without, call or prepayment penalties.

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FIRST AMERICAN FINANCIAL CORPORATION

AND SUBSIDIARY COMPANIES

Notes to Condensed Consolidated Financial Statements – (Continued)

(unaudited)

The composition of the investment portfolio at September 30, 2016, by credit rating, is as follows:

A- Ratings or higher	BBB+ to BBB- Ratings