B10. 6317, Accounting for Financial Instruments
Summer 2014
Stern School of Business, New York University
Professor Stephen Ryan (10-73 KMC, 998-0020, fax 995-4004, sryan@stern.nyu.edu, office hours M/W 4-5:15 and by appointment)
Morning class/Section 60 M/W 9-11:55, Afternoon class/Section 61 MW 1-3:55 (except 5/26 M class is replaced by 5/30 F class)
Tisch UC-25

Description of Course: This course provides a conceptually sound and comprehensive treatment of the complex, developing, and imperfectly consistent financial reporting (i.e., accounting and disclosure) rules for financial instruments and structured financial transactions. Two related facts provide the context for this course. First, market participants continually design new financial instruments and transactions and these new financial products often stress existing financial reporting rules. Second, the half-lives of financial reporting rules for financial instruments and transactions are short, perhaps about five years. For example, the FASB currently is engaged in major projects on financial reporting for: (1) financial instruments, with separate parts for classification and measurement and credit impairment, with final standards currently scheduled to be issued in the second half of 2014; and (2) leases, with no scheduled date to issue a final standard. The FASB also has minor projects on insurance contracts, repurchase agreements, and variable interest entity consolidation as well as research projects on hedge accounting and interest rate risk disclosures. Whether and when final standards will be issued is hard to predict, however. Substantial delays in many of these projects has occurred because the these projects were jointly conducted with the IASB beginning in 2008, but attempts to converge U.S. GAAP with IFRS since then typically have met with failure, with the boards ultimately agreeing to disagree.

Reflecting these facts, a primary goal of this course is to provide students with the intellectual tools to understand new financial reporting rules for financial instruments and transactions as they are written. Such understanding requires an awareness of the economically important features of the transactions and how these features generally are (and logically can be) only partly captured by financial reporting rules. This understanding is particularly important for auditors, who increasingly are expected to be able to understand complex accounting issues and to explain them to non-accountants.

Relatedly, a second primary goal of the course is for students to learn how to conduct GAAP research on complex accounting issues. This task involves reading the relevant GAAP rules, spending the often considerable time necessary to determine how those rules apply to the facts and circumstances of specific transactions, and addressing the ambiguity that sometimes remains regarding GAAP compliance and appropriate financial report disclosures. We will discuss problems and cases to help you learn how to conduct this research and the issues you should consider when faced with ambiguity. Auditors' career progress, legal exposures, reputations, and sense of self-worth can depend on how they (induce their clients to) resolve this ambiguity. Often, the simplest and best way to do so is for auditors to encourage their clients to make transparent disclosures.

Topical Coverage: The course begins with the three main measurement bases used in the mixed-attribute accounting model for financial instruments: (1) amortized cost accounting, typically subject to impairment write-downs for financial assets; (2) fair value accounting; and (2) FAS 5's incurred loss model for loss contingencies. We will discuss the distinct features of these measurement bases, how different measurement bases apply to specific financial instruments, the problems caused by mixed-attribute accounting for portfolios of financial instruments, and how these problems are mitigated in part through disclosure.

The course then proceeds to the accounting for structured financial transactions that bundle and/or unbundle and repackage the risk and value of simpler financial instruments and transactions. Some structured financial transactions, such as securitizations and repurchase agreements, raise the issue of sale versus secured borrowing accounting. Some transactions employ special purpose/variable interest entities, which raises the issue of consolidation.

The course finishes with the accounting for risk management activities, notably derivatives and hedging.

While this course focuses on U.S. GAAP for financial instruments and transactions, there is considerable and increasing overlap with international GAAP. Occasionally I will mention significant differences between U.S. and international GAAP.

Main Text Substitute: Accounting Standards: No good, up-to-date textbook exists that covers the course material. Hence, the main material for the course is the relevant accounting standards. FASB standards (FASs, FINs, FTBs, FSPs, EITFs, and DIGs) issued prior to the adoption of the Accounting Standards Codification in September 2009 (see the next section) are available online either at www.fasb.org (click on the Standards drop down menus at the top and then on pre-codification standards in this menus) or through the Accounting Standards Codification described below. While it may seem inconvenient to learn accounting this way, it is essential for auditors to be able to read and understand GAAP at the source.

The Accounting Standards Codification: As of September 2009, the FASB organizes pre-existing accounting standards (from all of the primary sources, not just the FASB) and issues new standards according to the Accounting Standards Codification (ASC). New standards are issued as Accounting Standards Updates (ASUs). ASUs are prefaced by brief summaries describing their purposes and effects. Significant ASUs contain basis for conclusions sections as well.

The ASC has strengths and weaknesses relative to the prior system. On the plus side, putting all of GAAP into a single, searchable database, with hyperlinks to implementation guidance and examples, significantly facilitates the conduct of accounting research. On the minus side, the ASC does not reliably exposit material in a coherent fashion, in part because it forces each standard into the same schema. It also does not contain the basis for conclusions sections of pre-existing standards or ASUs that explain what the FASB had in mind in setting financial reporting requirements. Lastly, even after using the ASC for several years, I find it very difficult to remember the relevant section numbers in the ASC's five-level-deep schema.

Full access to the ASC, including cross-referencing of pre-existing standards, is available to Stern accounting students on the codification website, asc.fasb.org, by clicking on Academic Accounting Access and using the username AAA51820 and the password N65MkER.

Other Text Substitutes: I summarize the most relevant aspects of accounting standards in my detailed, up-to-date class presentation slides. I will hand out those slides, as well as problems, cases, and other materials in class. I note that to conserve class time I will often skip over slides that contain background material in class; if you have questions about a slide I skip over, please ask in class or afterwards.

Another text substitute is my research-oriented monograph, Stephen G. Ryan, "Financial Reporting for Financial Instruments," *Foundations and Trends in Accounting*, 2011. In the course outline, I indicate the descriptive portions of this monograph that are relevant to the each session of the course. This monograph is posted on NYUClasses (see below).

Optional but Out-of-Date Text: A more extensive text substitute is Stephen G. Ryan, *Financial Instruments and Institutions: Accounting and Disclosure Rules*, 2007, John Wiley & Sons. I wrote this book for my Stern MBA class B10.3321, *Analysis of Financial Institutions and Financial Instruments*. I do not require this book for this course in part because it focuses considerably on financial analysis and in part because it has become increasingly out of date due to the significant standards issued since the publication of the second edition in 2007 (most notably FAS 157 [fair value measurement], FAS 159 [fair value option for financial instruments], FAS 166 [transfers of financial assets], and FAS 167 [variable interest entity consolidation]). However, the book contains considerable discussion of accounting beyond that in my monograph. In the course outline, I indicate the portions of this book that are relevant to the each session of the course.

Prerequisites: This course is only open to students that have completed the Stern undergraduate degree in the accounting CPA track.

Grading: Your grade will be determined as follows.

1. 40% 3-hour in-class "mid-term" on June 25 testing the course material covered in class up to that time (i.e., through VIE consolidation if I stay on schedule)
2. 40% group accounting research project. I will hand out the projects and group assignments on June 11, the groups will present the projects in class on July 2, and the written projects are due on July 4 at 5 pm.
3. 20% class participation that evidences preparation for class and considered thought about the material. Volume is far less important than quality of thought.

Group Accounting Research Project: On June 11, I will divide the class randomly into groups of 5-6 students each. I will give each group an actual or hypothetical transaction for which determining the required accounting treatment requires GAAP research and judgment. I will ask you specific questions about the economics of and accounting for the transaction. I will also ask you specific questions about considerations that go beyond the accounting, such as appropriate disclosures to require of clients, and risks that remain for auditors even if the accounting is done properly. You should attempt to resolve these questions and any related questions that arise through GAAP research and discussion among the group members. The groups will present their transactions and findings on the last day of class (July 2). Each group will have 20 minutes to present followed by 10 minutes of questions from me and the remainder of the class. Each group will hand in a written report by Friday July 4 at 5 pm; this report should attempt to summarize and address any issues raised in group presentation. The reports should not exceed 20 pages, double-spaced, 12 point font, 1 inch margins; shorter reports are fine as long as they adequately cover the material (12 pages has been the typical length in prior years). You may add appendices with the relevant GAAP, diagrams of the transactions, and similar supporting material.

NYUClasses/Access to Class Materials and Streaming Videos: While I will hand out all materials needed for the course in class, I will post the materials that are in electronic form on NYUClasses. These materials include files for streaming videos of each class. They also include the exams from 2010-2013 with answers. I will not use NYUClasses for other purposes. Please let me know if I have forgotten to post something on NYUClasses.

Course Schedule: The tentative sequence of class sessions is attached. Some of the readings and assignments may change over the course of the term. **NOTE THAT THERE IS NO CLASS ON MEMORIAL DAY (MONDAY MAY 26), AND THERE IS A REPLACEMENT CLASS ON FRIDAY MAY 30.**

Course Schedule (Tentative)

NOTE THAT THERE IS NO CLASS ON MEMORIAL DAY (MONDAY MAY 26) AND THERE IS A REPLACEMENT CLASS ON FRIDAY MAY 30.

5/28 Course Overview and Introduction to Financial Instruments, Interest Rate and Credit Risks, and Motivations for Structured Financial Transactions

Reading in Ryan Monograph: Chapters 1 and 2

Optional reading in Ryan Book: Preface, Chapter 1, Chapter 4, pp. 63-78, Chapter 5, pp. 93-97. Don't sweat the duration-related equations in Chapter 4, but try to follow the gist of the discussion.

5/30-6/2 (half) Amortized Cost and/versus Fair Value Accounting

Relevant Standards: APB 21 (amortized cost accounting) [ASC 835-30]
FAS 91 (deferral of certain fees and costs and related yield adjustments) [ASC 310-20]
FAS 157 (fair value measurement guidance) [ASC 820-10]
FAS 107 (fair value disclosures) [ASC 825-10]
FAS 159 (fair value option) [ASC 825-10]
The FASB issued exposure drafts on February 14, 2013 (important) and April 12, 2013 (miscellaneous items) regarding fair value measurement and classification

Reading in Ryan Monograph: Chapter 4, pp. 65-88 (note that the portion of Section 4.1.1 that pertains to impairment write-downs is related to the next session of the course). While optional, the remainder of this chapter surveys accounting research on topics related to fair value accounting and may be of interest.

Optional reading in Ryan Book: Chapter 6, pp. 131-149. Note this chapter is somewhat out of date due to the 2007 issuance of FAS 157 (fair value measurement) and FAS 159 (fair value option).

Prepare: Amortized cost accounting versus fair value accounting spreadsheet exercise. (Similar questions on past exams: 2010 Exam, questions 3 and 4 (partly); 2011 Exam, questions 2 and 3 (partly); 2012 Exam, question 3)
Citigroup's Super-Senior CDO Write-downs during 2007 thought questions
Recast Well Fargo's 2013 income statement to fair value. (Similar questions on past exams: 2012 exam, question 3; 2013 exam, question 2)

6/2 (half)-6/4 Investment Securities, Gains Trading, and the Various Impairment Accounting Models for Financial Assets

Relevant Standards: FAS 115 (investment securities) [ASC 320-10]
FSP FAS 115-2 and FAS 124-2 (recent change in other than temporary impairment guidance) [ASC 320-10]
EITF 99-20 (retained securities from securitizations)
FAS 114 and 118 (loan impairment) [ASC 310-10 and -40]
FAS 65 (mortgage impairment) [ASC 948]
SOP 03-3 (acquired impaired loans) [ASC 310-30]
The FASB issued an exposure draft on credit losses on December 20, 2012 (important)

Reading in Ryan Monograph: Section 4.1.1.

Optional reading in Ryan Book: Chapter 6, pp. 149-160.

Prepare: Impairment accounting numerical exercise
Impairment accounting research exercise
Wells Fargo 2013 gains trading case
Review Problem on Amortized Cost Accounting, Fair Value Accounting, and Other-than-Temporary Impairment
Question on past exams related to impairment accounting: 2010 Exam, questions 3 and 4 (partly); 2011 Exam, questions 2 and 3 (partly); 2012 Exam, question 2; 2013 Exam, question 2

6/9-6/11 The Incurred Loss Model for Loss Contingencies

Relevant Standards: The incurred loss model GAAP below is in ASC 450-20, 310-10-S99, and 942-310-25-1]
FAS 5 (the incurred loss model)
FIN 14 (interpretative guidance for FAS 5's capable of reasonable estimation condition)

Reading in Ryan Monograph: Chapter 3, pp. 29-46. While optional, the remainder of this chapter surveys accounting research on topics related to loan loss reserving under FAS 5's incurred loss model and may be of interest.

Optional reading in Ryan Book: Chapter 5. Note this chapter will become significantly out of date if the FASB issues a final standard on its credit impairment project, as it currently plans to do in the second half of 2014.

Prepare: Allowance for Loan Losses Numerical and Research Exercise, Including Thought Questions Regarding Loan Loss Reserving based on Historical Data in 2006
Wells Fargo's Allowance for Loan Losses Adequacy in 2013

Question on past exams related to incurred loss model: 2011 Exam, question 4; 2012 Exam, question 4; 2013 Exam, question 4

6/16-6/18 FAS 140 and 166: Sale versus Secured Borrowing Accounting for Securitizations and Repurchase Agreements

Relevant Standards: The GAAP listed below is in ASC 860
FAS 140 (transfers of financial instruments)
FAS 166 (significant amendment)
The FASB issued an exposure draft that would require most repurchase agreements—repos to maturity in particular—to be accounted for as secured borrowings on January 15, 2013 (medium important)

Reading in Ryan Monograph: Chapter 5, pp. 511-512 (through middle of first paragraph) and Section 5.2.2. While optional, Section 5.3.3 surveys accounting research on topics related to securitizations and may be of interest.

Optional reading in Ryan Book: Chapter 8. Note this chapter is significantly out of date due to the 2009 issuance of FAS 166, effective in 2010.

Prepare: Sale versus secured borrowing research exercise: Repo 105 (note ASU 2011-3 altered the critical portion of FAS 140)
Doral Financial Case
Questions on past exams related to securitizations: 2010 exam, question 5; 2011 exam, question 5 (partly); 2012 exam, question 5; 2013 exam, question 5 (the last part is partly related to the following session)

6/23 FIN 46(R) and FAS 167: Special Purpose/Variable Interest Entity Consolidation

Relevant Standards: The GAAP listed below is in ASC 810-10
FIN 46(R) (consolidation of variable interest entities)
FAS 167 (significant amendment)

Optional reading in Ryan Book: Chapter 9, pp. 235-244. Note this chapter is significantly out of date due to the 2009 issuance of FAS 167, effective in 2010.

Prepare: 2011 exam, question 5 (partly)
VIE consolidation research exercise
JPMC's Support of its Credit Card Securitization Vehicles in 2009
Consolidation of a Jointly Sponsored Asset-Backed Commercial Paper Conduit

6/25 In Class Exam

6/30 Derivatives and Hedging Overview

Relevant Standards: The GAAP listed below is in ASC 815
FAS 133 (main standard)
FAS 138 (amendments)
FAS 149 (more amendments)
FAS 161 (disclosures)
FSP FAS 133-1 and FIN45-1 (more disclosures)
Note: The FASB *intends* to simplify hedge accounting in the near term.

Reading Ryan Monograph: Chapter 5, pp. 111-123 (through the end of Section 5.2.1).

Optional reading in Ryan Book: Chapter 11

Prepare: Derivatives problems 1-4

7/2 Group Project Presentations